REQUEST FOR APPROVAL OF PROPOSED REGULATION SECTION 25128.5, AS AN ADDITION TO CALIFORNIA CODE OF REGULATIONS, TITLE 18, RELATING TO THE SINGLE-SALES FACTOR FORMULA ELECTION

On December 15, 2009, staff requested public input about a new regulation to implement the single-sales factor (SSF) formula election in Revenue and Taxation Code section 25128.5. Staff did not provide language at that time, but rather sought to elicit input on the content of a proposed regulation that would give instructions on how to make the SSF election and address numerous factual variations that might be encountered in making and accounting for the election. An interested parties meeting was held on January 28, 2010. There was considerable input and staff began drafting the proposed regulation.

On May 4, 2010, staff requested public input on proposed language for the new regulation implementing the SSF election. Language was provided for public review and comment at the interested parties meeting held on June 1, 2010. The main comments at this meeting related to the method of running the business assets test for entities on different fiscal years. After the meeting there was a comment requesting explanation of whether there could be a SSF election for groups with some entities engaged in qualified business activities. Modifications were made to the proposed language to address the qualified business activities concern and to change the business assets test to the first common 6-month period for entities on different fiscal years.

Staff asked the Franchise Tax Board at its June 22, 2010 meeting, to allow staff to move into the formal regulatory process to adopt a regulation to provide guidance on how to make the SSF election. The Board approved staff's request to move forward, and a formal Notice of Hearing was published on January 20, 2011.

On March 29, 2011, Laurie McElhatton of the department's Legal staff held the required public hearing at the Franchise Tax Board's central office to receive public comments on the proposed Regulation Section 25128.5. There were no attendees at the hearing and two written comments were submitted.

In response to the written comments, staff published a 15-day Notice setting forth certain "sufficiently related changes" within the meaning of Government Code section 11346.8, subdivision (c). The Notice was mailed on May 16, 2011, with comments due no later than May 31, 2011. One comment was received in response to the 15-day Notice. After review of the one comment, staff published a second 15-day Notice again setting forth "sufficiently related changes" within the meaning of Government Code section 11346.8, subdivision (c). The Notice was mailed on June 8, 2011, with comments due no later than June 23, 2011. No comments were received.

The comments received during the formal regulatory process were the following:

1. Apportioning trades or businesses that operate within partnerships that are not unitary with a corporate owner should be allowed to make the SSF election.

2. Please explain treatment of (1) non-profit corporations that are partners in a limited liability corporation or limited liability partnership, and (2) treatment of Community Development Financial Institutions.
3. Certain errors were addressed and additional examples suggested.

A detailed response to items raised in comments that were addressed in the changes that led to the 15-day Notice issued on May 16, 2011 is included as Exhibit A to this Report. The 15-day changes noticed on May 16, 2011 and the explanation for the changes are included as Exhibit B.

After the 15-day Notice was issued on May 16, 2011, a comment was received that required further changes. A detailed response to that comment is included as Exhibit C along with the associated changes that led to the 15-day Notice issued on June 8, 2011. The 15-day changes noticed on June 8, 2011 and explanation for the changes are included as Exhibit D. After the 15-day changes noticed on June 8, 2011, one comment was received. A response to this comment is included at Exhibit E. No further changes were required. The comments received during the formal regulatory process including the two 15-day comment periods are attached as Exhibit F. The final version of the regulation is included as Exhibit G to this Report.

Staff requests permission for final approval of the proposed Regulation section 25128.5, the language of which is set forth in Exhibit F of this package.

SUMMARY OF COMMENTS RECEIVED AT
FORMAL HEARING MARCH 29, 2011,
RESPONSES AND RECOMMENDATIONS
Proposed Regulation section 25128.5

Comments from Pillsbury Winthrop Shaw Pittman, Jeffrey Vessely, dated March 25, 2011 (also provided in hard copy at the March 29, 2011 hearing)

1. California Revenue and Taxation Code (CRTC) section 25128.5 authorizes "any apportioning trade or business" other than those described in CRTC section 25128(b) to annually elect to apportion by use of a single-sales factor all business income of such apportioning trade or business. It is well established that a taxpayer may have more than one trade or business making it necessary to determine business income attributable to each trade or business which is then apportioned by formula. When the activities of a partnership and a taxpayer do not constitute a unitary business, the taxpayer's share of the partnership's trade or business shall be treated as a separate trade or business of the taxpayer as set forth in California Code of Regulations (Regulation) section 25137-1(a) and (g). The proposed Regulation section 25128.5 recognizes at subsection (b)(6) that a taxpayer may make a separate single-sales factor (SSF) election for each apportioning trade or business. However, proposed Regulation section 25128.5(c)(2) fails to address the ability of a corporation to make a SSF election for nonunitary partnership interests.

Response:

The proposed regulation has been amended to address the commentator's concerns. A 15-day Notice was issued on May 16, 2011 to alert the public to the amendments. The amendments allow the SSF election to be made at the partnership level in order to determine distributive share items of income from the partnership to a non-unitary partner, in accordance with the provisions of California Code of Regulations section 25137-1, subsection (g), which treats the non-unitary partnership as a separate apportioning trade or business of the taxpayer. In addition, in response, staff reviewed the regulation and made further revisions to address apportioning trades or businesses operating in forms other than corporations to ensure that all apportioning trades or businesses may make the SSF election.
In many places in the proposed regulation, the language was changed to eliminate references to "combined reporting group" and "group" return because an apportioning trade or business may operate in a stand-alone entity that is not part of a combined reporting group and does not file a group return.

Subsection (c)(1) was modified to allow the SSF election to be made at the partnership level for distributive share items of income for nonunitary corporate partners. Examples were added to provide guidance. After the changes, subsection (c)(1) read as follows:

> ~~(2)~~(1) Partnerships to the extent owned by corporations. Corporations that elect single-sales factor formula apportionment must use the single-sales factor formula for distributive share items of income and factors from unitary partnerships. A partnership may make a single-sales factor formula election on Part B of schedule R-1 of form 565 or form 568 to determine California source income for its nonunitary partners.
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> Example 1: Partnership Y is owned 50 percent by Corporation A, which is a member of a combined reporting group, Group A, and 50 percent by Corporation B, which is a member of a combined reporting group, Group B. Partnership Y is unitary with Group A but not with Group B. If Group A makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from Partnership Y, adding 50 percent of the sales factor numerator and denominator of Partnership Y to those of Group A and adding 50 percent of total business income of Partnership Y to that of Group A. Partnership Y may make a single-sales factor formula election or may choose to not elect and remain on the three-factor formula to determine the California source income for Corporation B.
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> Example 2: A limited liability company M has three owners and has made no election for its classification for tax purposes so by default M is treated as a partnership. Each of the three owners of M operate an apportioning trade or business in addition to that operated by M. M is owned 25 percent by Corporation A, 25 percent by Corporation B, and 50 percent by Corporation C. M is unitary with Corporation C, but not with Corporations A or B. If Corporation C makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from M, adding 50 percent of the sales factor numerator and denominator of M to its own and adding 50 percent of total business income to its own total business income. M may make a single-sales factor method election to determine the California source income for Corporations A or B. Corporations A and B may independently make single-sales factor formula elections for their own separate apportioning trades or businesses that do not include M.
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> Example 3: Partnership X operates an apportioning trade or business and is owned 50 percent by a limited liability company (R) taxed as a partnership and 50 percent by a limited liability company (T) that has elected to be taxed as a corporation. All three business entities X, R, and T, are unitary. R is owned 5 percent by nonunitary Corporation A, 85 percent by unitary Corporation B, and 10 percent by nonunitary limited liability company S taxed as a partnership. The combined reporting group of X, R, T, and Corporation B is Group Y. The 50 percent distributive share of income and factors from X flows through to R and T. To determine the California source income for the 5 percent distributive share items

of income for nonunitary Corporation A, the single-sales factor formula may be used at the R level by R on Part B of schedule R-1 of form 568 using R's factors. The single-sales factor formula may also be used by unitary Corporation B which may elect to use the single-sales factor formula on Part B of schedule R-1 of form 100 if the same election is made by all members of Group Y. Corporation B would add to its own income and factors its 85 percent distributive share of income and factors from R (which would include R's 50 percent distributive share of income and factors from X) and the combined factors and income would be used on Corporation B's schedule R-1 of form 100 or Group Y's group return. To determine the California source income for the 10 percent distributive share items of income for nonunitary S, the single-sales factor formula may be used at the R level on Part B of schedule R-1 of form 568 using R's factors.

~~Example 1. Corporation A is a taxpayer. Corporation A and B are members of a combined reporting group. Corporation A owns 50 percent of the unitary Partnership Y. Accordingly, 50 percent of Partnership Y's income and factors are included in Corporation A and Corporation B's combined report. Corporation A makes a single sales factor formula election. Corporation A's sales factor will include the California sales of Partnership Y to the extent of its ownership interest. Partnership Y's payroll and property will be disregarded for apportionment purposes consistent with Corporation A's election.~~

~~Example 2. Same facts as Example 1 except that Corporation A owns 50 percent of the nonunitary Partnership Z instead of a 50 percent interest in unitary Partnership Y. Pursuant to California Code of Regulations section 25137-1, subsection (g), Corporation A's distributive share of Partnership Z's income is treated as income from a separate trade or business of Corporation A, and Corporation A's single sales factor election does not apply to its distributive share of determining Partnership Z's California sourced income. Partnership Z's California source income is separately determined utilizing the rules contained in California Code of Regulations, section 25137-1, subsection (g). Corporation A may make a separate single sales factor formula election to apportion its distributive share items of income from Partnership Z as a separate trade or business.~~

Subsection (c)(2) was modified to address apportioning trades or businesses that are owned by nonresidents and that operate either as a sole proprietorship or a partnership. While California residents pay income tax on all of their income, no matter the source, Revenue and Taxation Code section 17951 and California Code of Regulation section 17951-4 provide that nonresidents must determine their California source income and pay tax on that source income. In regards to a trade or business, regulation 17951-4 provides that the income of the business must be apportioned in accordance with Revenue and Taxation Code sections 25120 – 25139 (California Code of Regulations section 17951-4, subsection (c)(2)), the same apportionment scheme utilized by corporate taxpayers. Accordingly, those businesses owned by nonresidents may make

the SSF election provided all requirements are met. After the changes, subsection (c)(2) read as follows:

(2) Nonresidents.

(A) Sole Proprietorships. A nonresident individual who is a sole proprietor of a business that engages in activities partly within and partly without the state, as provided in California Code of Regulations section 17951-4, subsection (c)(2), may determine California source income using the single-sales factor formula.

Example 1: Beth Johnson is a nonresident and is the single owner of a sole proprietorship that operates an apportioning trade or business engaged in activities within and without California. Beth Johnson may use the single-sales factor formula on Part B of schedule R-1 for purposes of sourcing her income from the sole proprietorship.

Example 2: John Smith is a nonresident and is the single owner of a limited liability company that operates an apportioning trade or business engaged in activities within and without California. The limited liability company is treated as a disregarded entity for tax purposes. John Smith may make the single–sales factor formula election on Part B of schedule R-1 of form 568 for purposes of sourcing the limited liability company's income.

(B) Partnerships to the extent owned by individuals. A nonresident individual who is a partner in a partnership that engages in activities partly within and partly without the state may determine California source income, as provided in California Code of Regulations section 17951-4, subsection (d)(1), using the single-sales factor formula on Part B of schedule R-1 of form 565, but if the partnership does elect to use the single factor formula, the partnership must use the single-sales factor formula to determine California source income for all nonresident partners.

Example: Janet Jones and Bruce Johnson are nonresidents and are partners in an apportioning trade or business that operates as Partnership X. Each of the partners owns 50 percent of the partnership. Partnership X may elect to use the single-sales factor formula on Part B of schedule R-1 of form 565 to determine the California source income of the partners, but if Partnership X uses the single-sales factor formula, it must do so for both Janet Jones and for Bruce Johnson.

Subsection (b)(7) was modified to add the forms where the SSF election would be indicated for elections made by partnerships for nonunitary partners, by limited liability companies for nonunitary members, by qualified subchapter S subsidiaries that are not unitary with the S corporation owner, for individuals operating an apportioning trade or business as a sole proprietorships, and for nonresident individuals. After the changes subsection (b)(7) read as follows:

(7) Validity of Election. An election under this regulation will be considered valid if the following conditions are satisfied:

(A) The tax is computed in a manner consistent with the single-sales factor formula election, and

(B) A written notification of election is filed with the return on Part B of schedule R-1 ~~of~~ attached to form 100 (S Corporations file a form 100S, and water's-edge corporations file a form 100W), form 565 (for nonunitary partnerships), form 568 (for nonunitary limited liability companies), schedule QS (for nonunitary qualified Subchapter S subsidiaries), form 540 (for individuals), or form 540NR (for nonresident individuals).

Subsection (b)(6) was modified to provide more examples. After the changes subsection (b)(6) read as follows:

(6) A taxpayer that is engaged in more than one apportioning trade or business ~~as defined in Revenue and Taxation Code section 25128, subdivision (d)(6),~~ may make a separate election for each apportioning trade or business.

Example 1: Corporations A and B are taxpayers and are affiliated with each other, and are also affiliated with non-taxpayer Corporations C, D, E, F, G, H, and I. Corporations A, C, D, and G are engaged in one apportioning trade or ~~unitary~~ business and form a combined reporting group, Group X. Corporations B, E, F, H, and I are engaged in another separate apportioning trade or ~~unitary~~ business and form a combined reporting group, Group Y. Since both Corporations A and B are members of a combined reporting group that includes at least one California taxpayer~~s~~, ~~either~~ each may independently elect to file on a single-sales factor formula basis for purposes of apportioning business income of ~~with~~ their respective ~~unitary~~ combined reporting group~~s~~. It is not necessary for both Corporations A and B to make the same election, even though they are members of the same group of affiliated corporations. Corporation A, filing a group return for Group X, may make a single-sales factor formula election for Group X. Corporation B, filing a group return for Group Y, is not required to make a single-sales factor formula election.

Example 2: Corporation W is a taxpayer that owns 50 percent of two separate apportioning trade or businesses, Partnership J and Partnership K, but is not unitary with either partnership. Partnership J determines the California source income of Corporation W using the single-sales factor method on a timely filed original return on Part B of schedule R-1 of form 565. Partnership K makes no election and uses the standard three-factor formula to determine the California source income of Corporation W. Corporation W makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula.

Example 3: Corporation P is a taxpayer that is the single owner of three limited liability companies, Q, R, and S that are each disregarded entities for tax purposes and operate three distinct apportioning trade or businesses. P, Q, R and S are not unitary with one another. Q and R determine the California source income of Corporation P using the single-sales factor formula on timely filed original information returns on Part B of schedule R-1 of form 568. S makes no election and determines the California source income of Corporation P using the standard three-factor formula on Part A of schedule R-1 of form 568. Corporation P makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula on Part A of schedule R-1 of form 100.

Example 4: Same facts as Example 3, except that Corporation P and the disregarded limited liability companies Q, R, and S are unitary. The combined reporting group includes Corporation P (Q, R, and S), Corporation A, and Corporation B filing a group return for Group P. Group P makes a single-sales factor formula election on its timely filed original group return. Since Q, R, and S are disregarded entities operating as divisions of Corporation P and are unitary with each other and Corporations P, A, and B, the income and factors of Q, R, and S are added to those of Corporations P, A, and B, and the single-sales factor formula is used to apportion the income of Group P.

Example 5: Corporation T has elected to be an S corporation. It wholly owns Corporations U, V, and W, each of which satisfies the requirements to be a qualified Subchapter S subsidiary and, pursuant to an election by T, are treated as disregarded entities. T is unitary with W, while T, U and V are not unitary with one another and each operates a separate apportioning trade or businesses. U and V determine the California source income of Corporation T using the single-sales factor formula on a timely filed original return, form 100S filed by Corporation T, with the election indicated on Part B of schedule R-1 attached to schedule QS. Corporation T makes no single-sales factor formula election. Because W is unitary with T and T made no election, W may not determine Corporation T's California source income using the single-sales factor formula. Corporation T does the following: (1) apportions the business income from its separate apportioning trade or business using the standard three-factor formula, (2) adds the income and factors of unitary W to its own income and factors, and (3) adds the California source income from the separate apportioning trade or business of U and V as determined using the single-sales factor formula with U and V's sales factors.

Subsection (b)(5) was modified to add an example and make some minor changes to the language. After the changes, subsection (b)(5) read as follows:

(5) Election following forced de-combination.

(A) A taxpayer that is subsequently found to not be a member of the combined reporting group pursuant to a Franchise Tax Board audit

determination (represented by a notice of additional tax proposed to be assessed, a notice of proposed overpayment, notice of action on a claim for refund, or a letter from the tax auditor regarding a computational effect which does not result in a current year adjustment [e.g., a computation of net operating loss carryover]) may elect to use the single-sales factor formula on an amended return that will be treated as an original return for the purpose of the single-sales factor formula election. The election should ordinarily be made during the course of the audit examination so that the results of that election can be reflected in the applicable notices related to the examination. Except for claims for refund, this election after de-combination must be made no later than 60 days after the date of the applicable notice. This election may be made for each taxable year beginning with the year of de-combination through 60 days after the date of the applicable notice. The Franchise Tax Board may extend such 60-day period for good cause, not to exceed 180 days. In the case of a claim for refund for the entity that was erroneously included in the combined reporting group, a request for the single-sales factor formula election must be made in the claim itself or presented before issuance of the notice of action on the claim. Information to substantiate the effect of the election shall be provided to the Franchise Tax Board within a reasonable time after an election under this subsection is made.

Example 1: Corporations A, B, and C are included in a group return for calendar Years 1~~, 2, 3, 4, 5, and~~ through 6 that includes a single-sales factor formula election. On June 15 of Year 7 the Franchise Tax Board makes an audit determination that Corporation C was erroneously included in the combined report for every year. Corporation C must make the single-sales factor formula election for Years 1~~, 2, 3, 4, 5, and~~ through 6 by August 15 of Year 7. Thereafter, Corporation C may make the single-sales factor formula election on its timely filed original returns.

Example 2: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1~~, 2, 3, 4, 5, and~~ through 6 on December 26 of Year 7. There is no valid single-sales factor election for Years 1~~, 2, 3, 4, 5, and~~ through 6 because the election was made more than 180 days after the audit determination on June 15 of Year 7.

Example 3: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1~~, 2, 3, 4, 5, and~~ through 6 on September 10 of Year 7. There is a valid single-sales factor election for Years 1~~, 2, 3, 4, 5, and~~ through 6 provided Corporation C successfully shows good cause for electing more than 60 days after the audit determination of June 15 of Year 7.

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Corporation B determines that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4.

Corporation A determines that its apportioning trade or business is not unitary with Partnership X. Partnership X determines the California source income of Corporation A using the single-sales factor formula as properly indicated on Part B of schedule R-1 of forms 565 for Years 1 through 4. Corporation A makes no election for its separate apportioning trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2, with a determination dated July 15 of Year 6. Corporation B and Partnership X may file amended returns for Years 1 through 4 by no later than September 15 (60 days from the date of audit determination) of Year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula and Partnership X's factors. Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15, 2006 and may use the single-sales factor formula to determine the California source income of Corporation B on a timely filed original Part B of schedule R-1 of form 565 for that year.

Subsection (b)(3) was modified to add an example. After the change, subsection (b)(3) read as follows:

(3) An apportioning trade or business ~~Combined reporting groups~~ that includes one or more qualified business activities may make the single-sales factor election provided the apportioning trade or business ~~combined reporting group~~ does not derive more than 50 percent of its gross business receipts from qualified business activities.

Example 1: Corporation A is a bank or financial corporation. Corporations B and C are general corporations. Corporation A, B, and C are members of the same combined reporting group, Group X. Group X receives less than 50 percent of its gross business receipts from the activities of Corporation A. Accordingly, Corporation A may make the single-sales factor formula election along with Group X.

Example 2: Same facts as Example 1, except that Group X receives more than 50 percent of its gross business receipts from the activities of Corporation A. Corporation A must apportion pursuant to Revenue and Taxation Code section 25128, ~~subsection~~subdivision (b), and is precluded from making a single-sales factor formula election. Group X may not make the single-sales factor formula election.

Example 3: Partnership P conducts an apportioning trade or business and is owned 65 percent by Corporation W and 35 percent by Corporation T. Partnership P derives less than 50 percent of its gross business receipts from an extractive business activity. Partnership P, Corporation T, and Corporation W are not unitary

with each other. As a result, Corporation W and Corporation T may not independently decide whether to make a single-sales factor method election for their distributive share items of income from the nonunitary Partnership P. However, Partnership P may use the single-sales factor formula to determine California source income for Corporation W and Corporation T on Part B of schedule R-1 of form 565 using the Partnership P factor(s) because Partnership P's separate apportioning trade or business derives less than 50 percent of its gross business receipts from a qualified business activity.

The definition of "apportioning trade of business" at subsection (a)(2) was modified to (1) take out references to CRTC sections that require an apportioning trade or business to be a corporation, and (2) expressly list some of the different forms that an apportioning trade or business might take. After the changes, subsection (a)(2) read as follows:

(2) Apportioning trade or business. "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned because it has income derived from sources within this state and from sources outside this state. An apportioning trade or business can be conducted in many forms, including, but not limited to, the following:

(A) A corporation.

(B) A corporation that is a member of a combined reporting group.

(C) A division of a corporation engaged in a separate trade or business not unitary with the other trades or businesses of the corporation.

(D) A partnership to the extent owned by a corporate partner that is not unitary with the partnership, whether the corporation stands alone or is a member of a combined reporting group.

(E) A partnership to the extent owned by a partner who is an individual who is not a resident of California.

(F) A sole proprietorship that is operated by an individual who is not a resident of California.

The definition of "apportionment" at subsection (a)(3) was modified to take out the word "group" and to replace the words "combined report" with "an apportioning trade or business." These changes were made to remove the limitation that an apportioning trade or business must operate within a group or within a combined report. This was appropriate because an apportioning trade or business may be a stand-alone operation that is not a part of a combined reporting group.

(3) Apportionment. "Apportionment" is the means by which the total business income of an apportioning trade or business is assigned to this state under Revenue and Taxation Code sections 25128 through 25137 and section 25141.

A definition of "disregarded entity" was added at subsection (a)(11) so that fact patterns with single member disregarded limited liability companies (SMDLLCs) and qualified Subchapter S subsidiaries (QSubs) operating as divisions of a corporate parent could be discussed in the examples. Corporations can have two divisions that are not unitary with each other and therefore represent separate apportioning trade or businesses. It does not matter whether the divisions are within one corporation or are held through an entity disregarded for tax purposes and treated as a division. Therefore, a separate apportioning trade or business operating as a SMDLLC or QSub that is not unitary with the other business operations of its corporate parent also should be able to make the SSF election, and should make the election at the SMDLLC and QSub level.

> (11) Disregarded Entity. A "disregarded entity" is an entity described in California Code of Regulations section 23038(b)-2, subsection (a).

Definitions for "limited liability company" and "member" were added at subsections (a)(15) and (16) so that fact patterns involving limited liability companies (LLCs) could be discussed in the examples.

> (15) Limited liability company. A "limited liability company" is as defined at Revenue and Taxation Code section 17941, subdivision (d).

> (16) Member. "Member" is as defined by California Code of Regulations section 25106.5, subsection (b)(10).

A definition of "nonresident" was added at subsection (a)(19) and "resident" at (a)(24) so the terms could be used in the newly added subsection (c)(2) and examples.

> (19) Nonresident. A "nonresident" is as defined in California Code of Regulations section 17014.

> (24) Resident. A "resident" is as defined in Revenue and Taxation Code section 17014, subdivision (a), and California Code of Regulations section 17014, subsection (a).

A definition of "partnership" was added at subsection (a)(21). While the term "partnership" had been used in the proposed regulation prior to receiving this comment, it had not been defined. Accordingly, a definition was added.

> (21) Partnership. A "partnership" is as defined in Revenue and Taxation Code section 17008 and includes entities treated as partnerships as set forth in California Code of Regulations section 23038(b)-3.

Definitions were added for a "qualified Subchapter S subsidiary," "S corporation," and "sole proprietorship," at subsections (a)(23), (25), and (26). These definitions were needed so that fact patterns including these forms of business could be discussed in the examples.

> (23) Qualified Subchapter S subsidiary: A "qualified Subchapter S subsidiary" is as defined in Internal Revenue Code section 1361, subsection (b)(3), as incorporated by Revenue and Taxation Code section 23800 and as modified by Revenue and Taxation Code section 23800.5.
>
> (25) S corporation. An "S corporation" is as defined in Internal Revenue Code sections 1361 and 1362, as modified by Revenue and Taxation Code sections 23800.5 and 23801.
>
> (26) Sole Proprietorship. A "sole proprietorship" is an unincorporated trade or business that is operated by one individual.

A definition of "taxpayer" was added at subsection (a)(28) so the term could be used throughout the proposed regulation.

> (28) Taxpayer. "Taxpayer" means an individual, corporation, or partnership with a requirement to file a California franchise or income tax return.

A definition of "unitary" was added at subsection (a)(31) so that the term could be used throughout the proposed regulation.

> (31) Unitary. One corporation or partnership is "unitary" with another corporation or partnership if they are engaged in a unitary business.

Comments from Joyce Dillard dated March 29, 2011

1. "How are non-profit corporations treated in this calculation if they are a partner in a Limited Liability Corporation [sic] or Limited Liability Partnership."

Response:

A non-profit corporation that owns an LLC would be treated the same as any other corporation that owns an LLC, as explained in the changes made to the proposed regulation in the 15-day Notice issued on May 16, 2011. Those changes are also responsive to this comment. If the corporate owner is unitary with the LLC, then a SSF election may be made by the corporate owner for the group that includes the LLC (if the LLC is treated as a corporation or is disregarded) on Part B of schedule R-1 attached to form 100. If the LLC is

not unitary with the corporate owner, then the SSF election may be made at the LLC level to determine the California source income of the nonunitary member on Part B of schedule R-1 attached to form 568.

Limited liability partnerships are available only for law partnerships, accounting partnerships, and architect partnerships or partnerships providing services related to those three professions. Each of the partners in an LLP must be persons licensed to practice law, accounting, or architecture or persons licensed to provide professional LLP services in a jurisdiction outside of California. (Cal. Corp. Code sections 16101, 16951, 16959.) Accordingly, a non-profit corporation cannot be a partner in an LLP.

2. "How are CDFI Community Development Financial Institutions treated."

Response:

Provided the CDFI at issue meets the requirements of being a financial, it would be treated the same as any other entity engaged in qualified business activities. If the CDFI is part of a unitary group and that group has more than 50 percent of its gross business receipts from qualified business activities, then the group cannot make a SSF election. If the unitary group that includes the CDFI has 50 percent or less of its gross business receipts from qualified business activities, then the group may make the SSF election. If the CDFI is a stand-alone entity and qualifies as a financial, it may not make a SSF election as it is engaged in qualified business activities.

NOTE: 15 day changes are shown in underscores for additions and strikeouts for deletions.

Section 25128.5 is adopted to read:

§ 25128.5. Single-Sales Factor Formula Election.

(a) Definitions. For purposes of this regulation, the following definitions are applicable:

(1) Affiliated corporations. "Affiliated corporations" are corporations related by common ownership~~,without regard to unity~~.

(2) Apportioning trade or business. "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned ~~under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors. An apportioning trade or business includes at least one taxpayer member~~ because it has income derived from sources within this state and from sources outside this state. An apportioning trade or business can be conducted in many forms, including, but not limited to, the following:

(A) A corporation.

(B) A corporation that is a member of a combined reporting group.

(C) A division of a corporation engaged in a separate trade or business not unitary with the other trades or businesses of the corporation.

(D) A partnership to the extent owned by a corporate partner that is not unitary with the partnership, whether the corporation stands alone or is a member of a combined reporting group.

(E) A partnership to the extent owned by a partner who is an individual who is not a resident of California.

(F) A sole proprietorship that is operated by an individual who is not a resident of California.

(3) Apportionment. "Apportionment" is the means by which the total ~~group~~ business income of an apportioning trade or business ~~combined report~~ is assigned to this state under Revenue and Taxation Code sections 25128 through 25137 and section 25141.

(4) Banking or financial business activity. “Banking or financial business activity” means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

(5) Business assets. "Business assets" are assets, including intangible assets, other than stock of a member of the combined reporting group, which are used in the conduct of the business of the combined reporting group or would produce business income to the combined reporting group if the assets were sold.

Business assets are valued at net book value as of the date that electing taxpayers and non-electing taxpayers or non-taxpayers become members of a new combined reporting group. A copy of the taxpayer's valuation of the business assets must be made available when required by the Franchise Tax Board. The Franchise Tax Board may, in its sole discretion, allow an alternative valuation date if it determines that an alternative date would be more appropriate.

(6) Business asset test. The "business asset test" is the mechanism of comparing business assets to determine if members of a combined reporting group are required to use the standard formula under Revenue and Taxation Code section 25128 or the single-sales factor formula under Revenue and Taxation Code section 25128.5 and this regulation.

(7) Combined reporting group. A "combined reporting group" is as defined by California Code of Regulations section 25106.5, subsection (b)~~, paragraph~~ (3).

(8) Commencement date. The "commencement date" of a single-sales factor formula election is the first day of the period for which the election is made.

(9) Common Ownership. "Common ownership" exists if:

(A) A parent corporation owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,

(B) Stock cumulatively representing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph (A), or one or more other corporations that satisfy the conditions of this subparagraph.

(10) Corporation. References to “corporation” include a Subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation pursuant to Revenue and Taxation Code sections 23038 or 23038.5.

(11) Disregarded Entity. A "disregarded entity" is an entity described in California Code of Regulations section 23038(b)-2, subsection (a).

~~(11)~~(12) Good cause. "Good cause" shall have the same meaning as specified in Treasury Regulation section 1.1502-75(c).

~~(12)~~(13) Gross business receipts. "Gross business receipts" is as defined by Revenue and Taxation Code section 25128, ~~subsection~~ subdivision (d)(1).

~~(13)~~(14) Group Return. A "group return" is as defined by California Code of Regulations section 25106.5, subsection (b)(13).

(15) Limited liability company. A "limited liability company" is as defined at Revenue and Taxation Code section 17941, subdivision (d).

(16) Member. "Member" is as defined by California Code of Regulations section 25106.5, subsection (b)(10).

~~(14)~~(17) Net book value. "Net book value" is equal to an asset's original cost minus depreciation, depletion and amortization. Book value means the amount which an asset is carried on a balance sheet. Depreciation means the systematic write off of the cost of a tangible asset over the asset's useful life. Depletion means the systematic write off of the cost of harvesting or mining a natural resource. Amortization means the systematic write off of the cost of an intangible asset over the asset's useful life. Book value, depreciation, depletion and amortization will be reflected using United States Generally Accepted Accounting Principles (US GAAP). If any member of a combined reporting group does not maintain its books using US GAAP, the Franchise Tax Board may allow an alternative method of valuation of that member's business assets.

~~(15)~~(18) New combined reporting group. A "new combined reporting group" is a combined reporting group that is created by a new affiliation of two or more corporations, or by
the addition of one or more new members to an existing combined reporting group.

(19) Nonresident. A "nonresident" is as defined in California Code of Regulations section 17014.

~~(16)~~(20) Original return. The "original return" is the last return filed on or before the due date (taking extensions into account) regardless of the form on which it is filed or however it may be denominated. A return filed after the due date (taking extensions into account) regardless of the form on which it is filed or however it may be denominated may be an original return, if no other return has been filed, but it would not be a timely filed, original return.

(21) Partnership. A "partnership" is as defined in Revenue and Taxation Code section 17008 and includes entities treated as partnerships as set forth in California Code of Regulations section 23038(b)-3.

~~(17)~~(22) Qualified business activities. "Qualified business activities" are as defined in Revenue and Taxation Code section 25128, ~~subsection~~subdivision (c).

(23) Qualified Subchapter S subsidiary: A "qualified Subchapter S subsidiary" is as defined in Internal Revenue Code section 1361, subsection (b)(3), as incorporated by Revenue and Taxation Code section 23800 and as modified by Revenue and Taxation Code section 23800.5.

(24) Resident. A "resident" is as defined in Revenue and Taxation Code section 17014, subdivision (a), and California Code of Regulations section 17014, subsection (a).

(25) S corporation. An "S corporation" is as defined in Internal Revenue Code sections 1361 and 1362, as modified by Revenue and Taxation Code sections 23800.5 and 23801.

(26) Sole Proprietorship. A "sole proprietorship" is an unincorporated trade or business that is operated by one individual.

~~(18)~~(27) Standard formula. The "standard formula" is the three-factor method of apportionment as defined by Revenue and Taxation Code section 25128 and California Code of Regulations section 25128.

(28) Taxpayer. "Taxpayer" means an individual, corporation, or partnership with a requirement to file a California franchise or income tax return.

~~(19)~~(29) Taxpayer member. "Taxpayer member" is as defined by California Code of Regulations section 25106.5, subsection (b)~~, paragraph~~ (11).

~~(20)~~(30) Timely filed. A "timely filed" return is one filed on or before the due date (taking extensions into account).

(31) Unitary. One corporation or partnership is "unitary" with another corporation or partnership if they are engaged in a unitary business.

~~(21)~~(32) Unitary business. A “unitary business” consists of those activities required to be included in a combined report pursuant to Revenue and Taxation Code section 25101 and the published cases decided thereunder by the United States Supreme Court, the courts of this State, and the California State Board of Equalization. Activities constitute a "unitary business" if unity of ownership, unity of operation, and unity of use are present, or if the activities carried on within the state contribute to or are dependent upon the activities carried on without the state. California Code of Regulations section 25120, subsection (b), sets forth certain indicia and standards for determining whether activities constitute a single trade or business and are therefore unitary.

(b) Electing the Single-Sales Factor Formula.

(1) To make a single-sales factor formula election permitted by Revenue and Taxation Code section 25128.5, a taxpayer must make an election on a timely filed, original return for the year of the election. ~~In order F~~for an election ~~by a combined reporting group~~to be effective for purposes of apportioning the business income of a combined reporting group, each taxpayer member of the combined reporting group that is subject to taxation under Part 11 of the Revenue and Taxation Code must ~~affirmatively~~ make ~~this~~the election.

Example: Corporation P, a calendar year California taxpayer, has a subsidiary, Corporation A, which~~who~~ is also a calendar year California taxpayer. Corporation P and Corporation A are members of the same combined reporting group. On its separate

timely filed return, Corporation P makes a single-sales factor formula election. Conversely, on its separate timely filed return, Corporation A does not make a single-sales factor formula election. As a result, neither Corporation P nor Corporation A are deemed to have made a single-sales factor formula election.

(2) An election made on a group return is an election by each taxpayer member included in that group return. However, the election made on the group return will not have any effect if a taxpayer member of the combined reporting group files a separate return in which no election is made, unless subsection (b)(4)(C) applies.

(3) An apportioning trade or business ~~Combined reporting groups~~ that includes one or more qualified business activities may make the single-sales factor election provided the apportioning trade or business ~~combined reporting group~~ does not derive more than 50 percent of its gross business receipts from qualified business activities.

Example 1: Corporation A is a bank or financial corporation. Corporations B and C are general corporations. Corporation A, B, and C are members of the same combined reporting group, Group X. Group X receives less than 50 percent of its gross business receipts from the activities of Corporation A. Accordingly, Corporation A may make the single-sales factor formula election along with Group X.

Example 2: Same facts as Example 1, except that Group X receives more than 50 percent of its gross business receipts from the activities of Corporation A. Corporation A must apportion pursuant to Revenue and Taxation Code section 25128, ~~subsection~~subdivision (b), and is precluded from making a single-sales factor formula election. Group X may not make the single-sales factor formula election.

Example 3: Partnership P conducts an apportioning trade or business and is owned 65 percent by Corporation W and 35 percent by Corporation T. Partnership P derives less than 50 percent of its gross business receipts from an extractive business activity. Partnership P, Corporation T, and Corporation W are not unitary with each other. As a result, Corporation W and Corporation T may not independently decide whether to make a single-sales factor method election for their distributive share items of income from the nonunitary Partnership P. However, Partnership P may use the single-sales factor formula to determine California source income for Corporation W and Corporation T on Part B of schedule R-1 of form 565 using the Partnership P factor(s) because Partnership P's separate apportioning trade or business derives less than 50 percent of its gross business receipts from a qualified business activity.

(4) Deemed Single-Sales Factor Formula or Standard Formula Elections and Non-Elections.

~~(A) If a corporation that is a member of a combined reporting group is not itself subject to taxation under Part 11 of the Revenue and Taxation Code in the year for which the single sales factor formula election is made, but subsequently becomes subject to taxation under Part 11 of the Revenue and Taxation Code, that corporation shall be deemed to have elected with the other taxpayer members of the combined reporting group.~~

~~(B)~~(A) Corporations that are non-electing taxpayers that are subsequently found to be members of a combined reporting group as the result of a Franchise Tax Board audit determination (represented by a notice of additional tax proposed to be assessed, a notice of proposed overpayment, notice of action on a claim for refund, or a letter from the tax auditor regarding a computational effect which does not result in a current year adjustment [e.g., a computation of net operating loss carryover]) shall be deemed to have elected the single-sales factor formula if the value of the total business assets of the electing taxpayer(s) is greater than those of the non-electing taxpayer(s). The commencement date of the deemed single-sales factor formula election shall be the same as the commencement date of the electing taxpayers. If the value of total business assets of the electing taxpayers does not exceed the value of total business assets of the non-electing taxpayers, the single-sales factor formula election of each electing taxpayer is terminated as of the date the non-electing taxpayers are, pursuant to the audit determination, properly included in the same combined reporting group as the electing taxpayers. Non-electing taxpayers may not be deemed to have made a single-sales factor formula election if the Franchise Tax Board audit determination is withdrawn or otherwise overturned. For purposes of applying this paragraph, the business assets of other members of the combined reporting group that are not taxpayers shall not be taken into account.

Example 1: Corporation P is not a California taxpayer. It has two subsidiaries, Corporation A and Corporation B, that are California taxpayers, and another subsidiary, Corporation C, that is not a California taxpayer. Corporations P, A, and C are members of the same combined reporting group. Corporation A makes a single-sales factor formula election on its timely filed return which reflects the apportionment factors and income of Corporations P and C. Corporation B files a separate tax return as a standard formula non-electing taxpayer. Upon Franchise Tax Board audit, Corporation B is determined to be a member of the combined reporting group that includes Corporations A, P, and C. In the year of Corporation A's single-sales factor formula election, Corporation A's business assets are $500 million and Corporation B's business assets are $250 million. Based on the business asset test, Corporation B is deemed to have elected the single-sales factor formula, because Corporation A's business assets are greater than Corporation B's business assets. Corporations P and C's business assets are not taken into account in performing the business assets test, since neither P nor C are California taxpayers.

Example 2: Corporations A, B, and C are taxpayer members of the same combined reporting group. The original timely-filed group return for 2011 that was filed on behalf of each of them includes a single-sales factor election. Corporation D, which is owned by Corporation A, was not considered to be a member of Corporation A, B, and C's combined reporting group for 2011. Corporation D filed its own 2011 California tax return, which did not include a single-sales factor election. During an audit conducted in 2014, the FTB determined that Corporation D was a member of Corporation A, B, and C's combined reporting group for 2011. During 2011, Corporation D's business

assets were greater than Corporation A, B, and C's combined business assets. Consequently, the single-sales factor election that was initially made on behalf of Corporations A, B, and C for 2011 is disregarded. For purposes of determining any proposed assessments relating to 2011 for Corporations A, B, and C, the FTB will recalculate the combined reporting group's business income using the standard formula.

~~(C)~~(B) If a taxpayer member of a combined reporting group files a separate return based on the standard formula, while other taxpayer members of the combined reporting group included in a group return file based on the single-sales factor formula, the business asset test will determine which method must be used for all taxpayer members of the combined reporting group.

Example 1: Corporations A, B, C, and D are California taxpayer members of a combined reporting group. Corporations A, B, and C file a group return using the single-sales factor formula. Conversely, Corporation D files a separate return using the standard formula. Pursuant to the business asset test, because the business assets of the electing Corporations A, B, and C are greater than the business assets of the non-electing Corporation D, Corporation D is deemed to have elected the single-sales factor formula.

Example 2: Same facts as Example 1, except that the business assets of Corporation D are greater than the combined business assets of Corporations A, B, and C. There is no single-sales factor formula election for Corporations A, B and C.

~~(D)~~(C) When taxpayer members of a combined reporting group file separate returns because their relative tax years end on different dates and some taxpayer members have elected the single-sales factor formula, while others have not, for purposes of conducting the business asset test, the business assets for the electing and non-electing taxpayers will be compared for each common six-month period that occurs after January 1, 2011. Thereafter, the business assets test will be applied to the same common six-month period. The Franchise Tax Board may, in its sole discretion, allow an alternative method if it determines an alternative method would be more appropriate.

Example: Corporations A, B, C, and D are California taxpayer members of a combined reporting group. Corporations A, B, and C are calendar year taxpayers and are included in a group return. Their return filed for taxable year ending December 31, 2011 uses the single-sales factor formula. Conversely, Corporation D has a fiscal year end on June 30th. The return Corporation D files for the year end of June 30, 2012 uses the standard formula. The first common six-month period for taxable years beginning on or after January 1, 2011 for all of the taxpayers begins on July 1, 2011, and ends on June 30, 2012. The business assets for the last six months of 2011 for electing Corporations A, B, and C are compared to the business assets of non-electing Corporation D for the same time period. If the business assets of electing Corporations A, B, and C are greater than the business assets of non-electing Corporation D for the common six-month

period; then Corporation D is deemed to have elected the single-sales factor formula for apportionment. Conversely, if the business assets of non-electing Corporation D are greater than the business assets of Corporations A, B, and C for the common six-month period, there is no single-sales factor formula election for Corporations A, B, or C. For all taxable years thereafter, the business assets test will be based on a comparison of the business assets for the last six-month period of Corporation D's fiscal year.

(5) Election following forced de-combination.

(A) A taxpayer that is subsequently found to not be a member of the combined reporting group pursuant to a Franchise Tax Board audit determination (represented by a notice of additional tax proposed to be assessed, a notice of proposed overpayment, notice of action on a claim for refund, or a letter from the tax auditor regarding a computational effect which does not result in a current year adjustment [e.g., a computation of net operating loss carryover]) may elect to use the single-sales factor formula on an amended return that will be treated as an original return for the purpose of the single-sales factor formula election. The election should ordinarily be made during the course of the audit examination so that the results of that election can be reflected in the applicable notices related to the examination. Except for claims for refund, this election after de-combination must be made no later than 60 days after the date of the applicable notice. This election may be made for each taxable year beginning with the year of de-combination through 60 days after the date of the applicable notice. The Franchise Tax Board may extend such 60-day period for good cause, not to exceed 180 days. In the case of a claim for refund for the entity that was erroneously included in the combined reporting group, a request for the single-sales factor formula election must be made in the claim itself or presented before issuance of the notice of action on the claim. Information to substantiate the effect of the election shall be provided to the Franchise Tax Board within a reasonable time after an election under this subsection is made.

Example 1: Corporations A, B, and C are included in a group return for calendar Years 1~~, 2, 3, 4, 5, and~~ through 6 that includes a single-sales factor formula election. On June 15 of Year 7 the Franchise Tax Board makes an audit determination that Corporation C was erroneously included in the combined report for every year. Corporation C must make the single-sales factor formula election for Years 1~~, 2, 3, 4, 5, and~~ through 6 by August 15 of Year 7. Thereafter, Corporation C may make the single-sales factor formula election on its timely filed original returns.

Example 2: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1~~, 2, 3, 4, 5, and~~ through 6 on December 26 of Year 7. There is no valid single-sales factor election for Years 1~~, 2, 3, 4, 5, and~~ through 6 because the election was made more than 180 days after the audit determination on June 15 of Year 7.

Example 3: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1~~, 2, 3, 4, 5, and~~ through 6 on September 10 of Year 7. There is a valid single-sales factor election for Years 1~~, 2, 3, 4, 5, and~~ through 6 provided Corporation C successfully shows good cause for electing more than 60 days after the audit determination of June 15 of Year 7.

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Corporation B determines that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4. Corporation A determines that its apportioning trade or business is not unitary with Partnership X. Partnership X determines the California source income of Corporation A using the single-sales factor formula as properly indicated on Part B of schedule R-1 of forms 565 for Years 1 through 4. Corporation A makes no election for its separate apportioning trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2, with a determination dated July 15 of Year 6. Corporation B and Partnership X may file amended returns for Years 1 through 4 by no later than September 15 (60 days from the date of audit determination) of Year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula and Partnership X's factors. Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15, 2006 and may use the single-sales factor formula to determine the California source income of Corporation B on a timely filed original Part B of schedule R-1 of form 565 for that year.

(6) A taxpayer that is engaged in more than one apportioning trade or business ~~as defined in Revenue and Taxation Code section 25128, subdivision (d)(6),~~ may make a separate election for each apportioning trade or business.

Example 1: Corporations A and B are taxpayers and are affiliated with each other, and are also affiliated with non-taxpayer Corporations C, D, E, F, G, H, and I. Corporations A, C, D, and G are engaged in one apportioning trade or ~~unitary~~ business and form a combined reporting group, Group X. Corporations B, E, F, H, and I are engaged in another separate apportioning trade or ~~unitary~~ business and form a combined reporting group, Group Y. Since both Corporations A and B are members of a combined reporting group that includes at least one California taxpayer~~s~~, ~~either~~ each may independently elect to file on a single-sales factor formula basis for purposes of apportioning business income of ~~with~~ their respective ~~unitary~~ combined reporting group~~s~~. It is not necessary for both Corporations A and B to make the same election, even though they are members of the same group of affiliated corporations. Corporation A, filing a group return

for Group X, may make a single-sales factor formula election for Group X. Corporation B, filing a group return for Group Y, is not required to make a single-sales factor formula election.

Example 2: Corporation W is a taxpayer that owns 50 percent of two separate apportioning trade or businesses, Partnership J and Partnership K, but is not unitary with either partnership. Partnership J determines the California source income of Corporation W using the single-sales factor method on a timely filed original return on Part B of schedule R-1 of form 565. Partnership K makes no election and uses the standard three-factor formula to determine the California source income of Corporation W. Corporation W makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula.

Example 3: Corporation P is a taxpayer that is the single owner of three limited liability companies, Q, R, and S that are each disregarded entities for tax purposes and operate three distinct apportioning trade or businesses. P, Q, R and S are not unitary with one another. Q and R determine the California source income of Corporation P using the single-sales factor formula on timely filed original information returns on Part B of schedule R-1 of form 568. S makes no election and determines the California source income of Corporation P using the standard three-factor formula on Part A of schedule R-1 of form 568. Corporation P makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula on Part A of schedule R-1 of form 100.

Example 4: Same facts as Example 3, except that Corporation P and the disregarded limited liability companies Q, R, and S are unitary. The combined reporting group includes Corporation P (Q, R, and S), Corporation A, and Corporation B filing a group return for Group P. Group P makes a single-sales factor formula election on its timely filed original group return. Since Q, R, and S are disregarded entities operating as divisions of Corporation P and are unitary with each other and Corporations P, A, and B, the income and factors of Q, R, and S are added to those of Corporations P, A, and B, and the single-sales factor formula is used to apportion the income of Group P.

Example 5: Corporation T has elected to be an S corporation. It wholly owns Corporations U, V, and W, each of which satisfies the requirements to be a qualified Subchapter S subsidiary and, pursuant to an election by T, are treated as disregarded entities. T is unitary with W, while T, U and V are not unitary with one another and each operates a separate apportioning trade or businesses. U and V determine the California source income of Corporation T using the single-sales factor formula on a timely filed original return, form 100S filed by Corporation T, with the election indicated on Part B of schedule R-1 attached to schedule QS. Corporation T makes no single-sales factor formula election. Because W is unitary with T and T made no election, W may not determine Corporation T's California source income using the single-sales factor formula. Corporation T does the following: (1) apportions the business income from its

separate apportioning trade or business using the standard three-factor formula, (2) adds the income and factors of unitary W to its own income and factors, and (3) adds the California source income from the separate apportioning trade or business of U and V as determined using the single-sales factor formula with U and V's sales factors.

(7) Validity of Election. An election under this regulation will be considered valid if the following conditions are satisfied:

(A) The tax is computed in a manner consistent with the single-sales factor formula election, and

(B) A written notification of election is filed with the return on Part B of schedule R-1 ~~of~~ attached to form 100 (S Corporations file a form 100S, and water's-edge corporations file a form 100W), form 565 (for nonunitary partnerships), form 568 (for nonunitary limited liability companies), schedule QS (for nonunitary qualified Subchapter S subsidiaries), form 540 (for individuals), or form 540NR (for nonresident individuals).

(8) Time for making the election.

(A) The election must be made on a timely filed, original return.

Example: Corporation P is not a California taxpayer, but it has three subsidiaries, Corporations A, B, and C that are taxpayers and are part of its unitary business. No single-sales factor formula election is filed prior to the due date (taking extensions into account) for filing a return. After the due date (taking extensions into account), a delinquent original California return is filed with a single-sales factor formula election by Corporation P, stating that it now believes it had nexus in California. Because the election was not made on a timely filed, original return, there is no valid election.

(B) Timely filings which only supplement a previously filed return, or correct mathematical or other errors, shall be considered as incorporating the previously filed return, to the extent not inconsistent, and shall be treated as the original return for purposes of making a single-sales factor formula election. Any timely filings that clearly reflect an intent to withdraw an election made on a previously filed return shall be treated as an original return.

Example 1: Corporation A is a calendar year taxpayer. Its return is due March 15. But if it files its return on or before October 15, an extension is automatically granted to October 15. If it fails to file a return by October 15, no extension exists. Under the paperless extension process, the return is timely if it is filed on or before October 15.

Corporation A files its original return on October 15 of the year. The original return is timely filed, and any single-sales factor formula election contained therein shall be effective for the year for which the return is filed.

Example 2: Same facts as Example 1 except that Corporation A files its original return on May 15 of the year. The original return is timely filed, and any single-sales factor formula election contained therein shall be effective for the year for which the return is filed.

Example 3: Same facts as Example 2 except that Corporation A files a second return on October 15. Under this regulation, Corporation A's original return was filed on October 15. The single-sales factor formula election must be made by that time. If Corporation A's May 15th filing makes a single-sales factor formula election, and the election is withdrawn in the October 15th filing, the election made on May 15th has no effect. If Corporation A's May 15th filing makes a single-sales factor formula election and the October 15th filing is silent as to the single-sales factor formula election but the calculation of the tax due on the return is consistent with making a single-sales factor formula election, then the single-sales factor formula election made in the May 15th filing is incorporated into the October 15th filing, which will be considered as the original return. If Corporation A's May 15th filing does not make a single-sales factor formula election, but a single-sales factor formula election is made on the October 15th filing, Corporation A has made a single-sales factor formula election and the October 15th filing is the original return.

Example 4: Corporation B, a calendar year taxpayer, files a return on February 15. Corporation B's return is treated as being filed on March 15, which is the date the election is considered to have been made. Any return filed after March 15 (the due date of the return) will be considered an amended return.

Example 5: Corporation C, a calendar year taxpayer, has a due date for its return of March 15. It files a return on February 15 and files a second return on March 10. The return filed on March 10 is treated as the original return for the year. The election to file on a single-sales factor formula basis must be made on the March 10 filing to be effective. If Corporation C's February 15 filing makes a single-sales factor formula election and the March 10 filing uses the standard formula and does not make an election, the election made on the February 15 return has no effect. If Corporation C's February 15th filing did not make a single-sales factor formula election and a single-sales factor formula election is made on the March 10th filing, Corporation C has made a single-sales factor formula election.

(c) Miscellaneous Provisions.

~~(1) Affiliated corporations not engaged in the same unitary business. A group of affiliated corporations that are engaged in more than one unitary business may make a single sales factor formula election with respect to one or more of the businesses, but need not elect for all of its businesses.~~

~~Example: Corporations A and B are California taxpayers and are affiliated with each other and with Corporations C, D, E, F, G, H, and I. Corporations A, C, D, and G are engaged in one unitary business, Group X. Corporations B, E, F, H, and I are engaged in another separate unitary business, Group Y. Since both Corporations A and B are California taxpayers, either may elect to file on a single-sales factor formula basis with~~

~~their respective unitary group. It is not necessary for both Corporations A and B to make the same election, even though they are members of the same group of affiliated corporations. Corporation A, filing a group return for Group X, may make a single-sales factor formula election for Group X. Corporation B, filing a group return for Group Y, is not required to make a single sales factor formula election.~~

~~(2)~~(1) Partnerships to the extent owned by corporations. Corporations that elect single-sales factor formula apportionment must use the single-sales factor formula for distributive share items of income and factors from unitary partnerships. A partnership may make a single-sales factor formula election on Part B of schedule R-1 of form 565 or form 568 to determine California source income for its nonunitary partners.

Example 1: Partnership Y is owned 50 percent by Corporation A, which is a member of a combined reporting group, Group A, and 50 percent by Corporation B, which is a member of a combined reporting group, Group B. Partnership Y is unitary with Group A but not with Group B. If Group A makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from Partnership Y, adding 50 percent of the sales factor numerator and denominator of Partnership Y to those of Group A and adding 50 percent of total business income of Partnership Y to that of Group A. Partnership Y may make a single-sales factor formula election or may choose to not elect and remain on the three-factor formula to determine the California source income for Corporation B.

Example 2: A limited liability company M has three owners and has made no election for its classification for tax purposes so by default M is treated as a partnership. Each of the three owners of M operate an apportioning trade or business in addition to that operated by M. M is owned 25 percent by Corporation A, 25 percent by Corporation B, and 50 percent by Corporation C. M is unitary with Corporation C, but not with Corporations A or B. If Corporation C makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from M, adding 50 percent of the sales factor numerator and denominator of M to its own and adding 50 percent of total business income to its own total business income. M may make a single-sales factor method election to determine the California source income for Corporations A or B. Corporations A and B may independently make single-sales factor formula elections for their own separate apportioning trades or businesses that do not include M.

Example 3: Partnership X operates an apportioning trade or business and is owned 50 percent by a limited liability company (R) taxed as a partnership and 50 percent by a limited liability company (T) that has elected to be taxed as a corporation. All three business entities X, R, and T, are unitary. R is owned 5 percent by nonunitary Corporation A, 85 percent by unitary Corporation B, and 10 percent by nonunitary limited liability company S taxed as a partnership. The combined reporting group of X, R, T, and Corporation B is Group Y. The 50 percent distributive share of income and factors from X flows through to R and T. To determine the California source income for the 5 percent distributive share items of income for nonunitary Corporation A, the single-sales factor formula may be used at the R level by R on Part B of schedule R-1 of form 568 using R's factors. The single-sales factor formula may also be used by unitary

Corporation B which may elect to use the single-sales factor formula on Part B of schedule R-1 of form 100 if the same election is made by all members of Group Y. Corporation B would add to its own income and factors its 85 percent distributive share of income and factors from R (which would include R's 50 percent distributive share of income and factors from X) and the combined factors and income would be used on Corporation B's schedule R-1 of form 100 or Group Y's group return. To determine the California source income for the 10 percent distributive share items of income for nonunitary S, the single-sales factor formula may be used at the R level on Part B of schedule R-1 of form 568 using R's factors.

~~Example 1. Corporation A is a taxpayer. Corporation A and B are members of a combined reporting group. Corporation A owns 50 percent of the unitary Partnership Y. Accordingly, 50 percent of Partnership Y's income and factors are included in Corporation A and Corporation B's combined report. Corporation A makes a single-sales factor formula election. Corporation A's sales factor will include the California sales of Partnership Y to the extent of its ownership interest. Partnership Y's payroll and property will be disregarded for apportionment purposes consistent with Corporation A's election.~~

~~Example 2. Same facts as Example 1 except that Corporation A owns 50 percent of the nonunitary Partnership Z instead of a 50 percent interest in unitary Partnership Y. Pursuant to California Code of Regulations section 25137-1, subsection (g), Corporation A's distributive share of Partnership Z's income is treated as income from a separate trade or business~~ of Corporation A, and ~~Corporation A's single sales factor election does not apply to its distributive share of determining Partnership Z's California sourced income. Partnership Z's California source income is separately determined utilizing the rules contained in California Code of Regulations, section 25137-1, subsection (g). Corporation A may make a separate single sales factor formula election to apportion its distributive share items of income from Partnership Z as a separate trade or business.~~

(2) Nonresidents.

(A) Sole Proprietorships. A nonresident individual who is a sole proprietor of a business that engages in activities partly within and partly without the state, as provided in California Code of Regulations section 17951-4, subsection (c)(2), may determine California source income using the single-sales factor formula.

Example 1: Beth Johnson is a nonresident and is the single owner of a sole proprietorship that operates an apportioning trade or business engaged in activities within and without California. Beth Johnson may use the single-sales factor formula on Part B of schedule R-1 for purposes of sourcing her income from the sole proprietorship.

Example 2: John Smith is a nonresident and is the single owner of a limited liability company that operates an apportioning trade or business engaged in activities within and without California. The limited liability company is treated as a disregarded entity for tax purposes. John Smith may make the single–sales factor formula election on

Part B of schedule R-1 of form 568 for purposes of sourcing the limited liability company's income.

(B) Partnerships to the extent owned by individuals. A nonresident individual who is a partner in a partnership that engages in activities partly within and partly without the state may determine California source income, as provided in California Code of Regulations section 17951-4, subsection (d)(1), using the single-sales factor formula on Part B of schedule R-1 of form 565, but if the partnership does elect to use the single factor formula, the partnership must use the single-sales factor formula to determine California source income for all nonresident partners.

Example: Janet Jones and Bruce Johnson are nonresidents and are partners in an apportioning trade or business that operates as Partnership X. Each of the partners owns 50 percent of the partnership. Partnership X may elect to use the single-sales factor formula on Part B of schedule R-1 of form 565 to determine the California source income of the partners, but if Partnership X uses the single-sales factor formula, it must do so for both Janet Jones and for Bruce Johnson.

(3) Changes in affiliation. Elections are made at the end of each taxable year when changes in affiliation are known. When a corporation is acquired by a combined reporting group and becomes unitary mid-year, the taxpayer members of the combined reporting group have the option of electing to use the single-sales factor formula at the end of that taxable year. The income and factors of the acquired entity are not included in the combined report for the portion of the year before acquisition, and the acquired entity must file a return reflecting its income from California sources and has the option of making its own election for that time period, consistent with this regulation. When a combined reporting group sells a corporation, at the end of the year the taxpayer members of the combined reporting group have the option of making a single-sales factor formula election for the group. The combined reporting group does not include the income and factors of the divested entity for the time period after the sale. The divested entity must file its own tax return for the portion of the year after the sale and has the option to make its own single-sales factor formula election for that portion of the year.

Example 1.: Corporation X and its unitary subsidiaries are members of a combined reporting group, Group W, which files on a calendar year basis. Corporation X is a member of Group W from January 1 to June 15 of Year 1. The group return filed by Group W includes Corporation X's income and factors for January 1 through June 14 of Year 1. Group W's taxpayers do not elect to use the single-sales factor formula. Corporation X may make its own single-sales factor formula election for the period starting June 15 through December 31 of Year 1.

Example 2.: Corporation A and its unitary subsidiaries B and C are calendar year taxpayers and members of a combined reporting group, Group R. Corporation A acquires Corporation X on June 15 of Year 1. For Year 1, a group return is filed on behalf of the members of Group R with a single-sales factor formula election. The single-sales factor formula election applies to Corporation X for June 15 through December 31 of Year 1.

(d) This regulation shall be applicable to taxable years beginning on or after January 1, 2011.

Note: Authority cited: Section 19503, Revenue and Taxation Code.
Reference cited: Sections 25113 and 25128.5, Revenue and Taxation Code.

TITLE 18. FRANCHISE TAX BOARD
PROPOSED REGULATION SECTION 25128.5,
RELATING TO SINGLE-SALES FACTOR METHOD ELECTION

A hearing was held on March 29, 2011, by Laurie J. McElhatton of the Franchise Tax Board Legal Division, the "hearing officer," on proposed new Regulation section 25128.5, which was noticed in the California Regulatory Notice Register on January 20, 2011. Revenue and Taxation Code section 25128.5 was enacted in 2009. It allows apportioning trades or businesses to elect to apportion their business income to California based solely on the sales factor. Revenue and Taxation Code section 25128.5, subdivision (c), allows the Franchise Tax Board to issue regulations necessary or appropriate regarding the election. The proposed regulation, if adopted, would provide guidance on how the election is made.

Department staff reviewed the proposed regulations and considered the comments submitted before and after the hearing. The hearing officer recommends that certain amendments to the proposed regulation be made to clarify the different forms that an apportioning trade or business can take and that (1) partnerships and disregarded entities that are not unitary with their owners may use the single-sales factor formula to determine California source income for the nonunitary owner, because they are treated as separate trades or businesses of the owners, (2) sole proprietorships owned by nonresidents may use the single-sales factor formula, and (3) partnerships may use the single-sales factor formula to the extent they are owned by nonresident individuals.

The hearing officer also recommends that there be certain deletions for redundant or unnecessary subsections. All of the amendments recommended by the hearing officer are reflected in the attachment hereto and meet the standards to be treated as either nonsubstantial or sufficiently related changes (within the meaning of Govt. Code section 11346.8). Deletions to the indicated regulation are reflected by strikeout, and additions to the regulation are reflected by underscore. The proposed changes are summarized below:

1. Subsection (a)(1), the definition of "affiliated corporations," is revised to delete the words "without regard to unity." The definition of "affiliated corporations" is needed so that the term may be used to describe the situation where corporations that have common ownership, are not in one apportioning trade or business, but are in fact in separate apportioning trades or businesses. In this scenario the affiliated corporations may make separate elections for each separate apportioning trade or business. The term "affiliated corporations" only addresses the common ownership between the corporations. It is not necessary to include the language "without regard to unity" and including that phrase may lead to confusion, hence it was deleted.

   > Affiliated corporations. "Affiliated corporations" are corporations related by common ownership~~. without regard to unity~~.

2. Subsection (a)(2), the definition of "apportioning trade or business," is revised to clarify the different forms an apportioning trade or business can take. The prior version was not explicit in addressing whether the election may be made by an apportioning trade or business that operates as a nonunitary division of a corporation, a partnership that

is not unitary with a corporate partner and therefore is a separate apportioning trade or business, a sole proprietorship owned by a nonresident, or a partnership to the extent owned by an individual nonresident:

(2) Apportioning trade or business. "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned ~~under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors. An apportioning trade or business includes at least one taxpayer member~~ because it has income derived from sources within this state and from sources outside this state. An apportioning trade or business can be conducted in many forms, including, but not limited to, the following:

(A) A corporation.

(B) A corporation that is a member of a combined reporting group.

(C) A division of a corporation engaged in a separate trade or business not unitary with the other trades or businesses of the corporation.

(D) A partnership to the extent owned by a corporate partner that is not unitary with the partnership, whether the corporation stands alone or is a member of a combined reporting group.

(E) A partnership to the extent owned by a partner who is an individual who is not a resident of California.

(F) A sole proprietorship that that is operated by an individual who is not a resident of California.

3. Subsection (a)(3), the definition of "apportionment" is modified to delete a reference to "group" business income of a "combined report" which does not address situations where the apportioning trade or business is operated within one corporation so that no combined report is necessary. Accordingly, the language is revised to delete "group" with no replacement term and to delete "combined report" and replace it with "apportioning trade or business."

(3) Apportionment. "Apportionment" is the means by which the total ~~group~~ business income of an apportioning trade or business ~~combined report~~ is assigned to this state under Revenue and Taxation Code sections 25128 through 25137 and section 25141.

4. The word "Subchapter" is capitalized at subsection (a)(10) for the definition of corporation to be consistent with capitalization in existing sections of the Revenue and Taxation Code and to be consistent herein with capitalization for "qualified Subchapter S subsidiaries."

(10) Corporation. References to “corporation” include a Subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation pursuant to Revenue and Taxation Code sections 23038 or 23038.5.

5. A definition of a "disregarded entity" is added at subsection (a)(11) because single member disregarded limited liability companies and qualified Subchapter S subsidiaries have been included in the examples at subsection (b)(6) in response to comments received by the hearing officer requesting clarification of treatment of entities operating as nonunitary divisions of a taxpayer. The definition is taken from California Code of Regulations section 23038(b)-2, subsection (a).

(11) Disregarded Entity. A "disregarded entity" is an entity described in California Code of Regulations, section 23038(b)-2, subsection (a).

6. A definition of a "limited liability company" is added at subsection (a)(15) because references to limited liability companies are added to the proposed regulation in subsections (b) and (c).

(15) Limited liability company. A "limited liability company" is as defined at Revenue and Taxation Code section 17941, subdivision (d).

7. A definition of "member" is added at subsection (a)(16) for guidance because the term is used in the proposed regulation. There is a distinction to be made between a member of a combined reporting group that is a California taxpayer ("taxpayer member") and a member of a combined reporting group that is not a California taxpayer ("member").

(16) Member. "Member" is as defined by California Code of Regulations, section 25106.5, subsection (b)(10).

8. A definition of "nonresident" is added at subsection (a)(19). Nonresident sole proprietorships and nonresident individual owners of partnerships may operate apportioning trades or businesses. Subsection (c)(2) is added to provide instructions indicating that California source income of the sole proprietor and the individual partner may be determined using the single-sales factor formula. Since the term "nonresident" is used in subsection (c)(2), a definition is added.

(19) Nonresident. A "nonresident" is as defined in California Code of Regulations section 17014.

9. A definition of "partnership" is added at subsection (a)(21) because the term is used at subsections (a), (b), and (c). The definition was partially taken from California Code of Regulations section 25137-1, subsection (a), with an added reference to California Code of Regulations section 23038(b)-3 for clarity because eligible entities with two or more owners may elect be treated as a partnership or be treated as a partnership by default.

(21) Partnership. A "partnership" is as defined in Revenue and Taxation Code section 17008 and includes entities treated as partnerships as set forth in California Code of Regulations section 23038(b)-3.

10. A definition of "qualified Subchapter S subsidiary" is added at subsection (a)(23) because this term is used in an example in subsection (b).

(23) Qualified Subchapter S subsidiary: A "qualified Subchapter S subsidiary" is as defined in Internal Revenue Code section 1361, subsection (b)(3), as incorporated by Revenue and Taxation Code section 23800 and as modified by Revenue and Taxation Code section 23800.5.

11. A definition of "resident" is added at subsection (a)(24) because the term "resident" is used in subsection (c) and hence a definition was warranted for purposes of clarity.

(24) Resident. A "resident" is as defined in Revenue and Taxation Code section 17014, subdivision (a), and California Code of Regulations section 17014, subsection (a).

12. A definition of "S corporation" is added at subsection (a)(25) because the term is used in subsections (a) and (b). The definition refers directly to Internal Revenue Code sections 1361 and 1362 as modified by Revenue and Taxation Code sections 23800.5 and 23801. Revenue and Taxation Code section 23801 recognizes S corporations when a federal election to be an S corporation has been made and all requirements are met. Including a definition of "S corporation" allows use of that term when discussing the qualified Subchapter S subsidiaries that are disregarded entities and treated as a division of the S corporation, and also for examples involving an S corporation. This provides clarity because an apportioning trade or business might be operated within a qualified Subchapter S subsidiary that is not unitary with the parent S corporation, but is treated as a division of the S corporation.

(25) S corporation. "S corporation" is as defined in Internal Revenue Code sections 1361 and 1362, as modified by Revenue and Taxation Code sections 23800.5 and 23801.

13. A definition of "sole proprietorship" is added at subsection (a)(26) because the term is used in the newly added subsection (c)(2)(A) that clarifies that a sole proprietorship operating an apportioning trade or business may determine California source income of the owner using the single-sales factor formula.

(26) Sole Proprietorship. A "sole proprietorship" is an unincorporated trade or business that is operated by one individual.

14. A definition of "taxpayer" is added at subsection (a)(28) because the term is used in subsection (b)(5) where "business assets" is defined, subsection (b) where electing the single-sales factor formula is explained, and subsection (c)(3) where changes in

affiliation are discussed. The definition is taken from California Code of Regulations section 25113, subsection (b)(11).

> (28) Taxpayer. "Taxpayer" means an individual, corporation, or partnership with a requirement to file a California franchise or income tax return.

15. A definition of "unitary" is added at subsection (a)(31) because the term is used at subsections (a), (b), and (c), and hence a definition is needed for clarity. The definition of "unitary business" is already included in the proposed regulation and is referenced.

> (31) Unitary. One corporation or partnership is "unitary" with another corporation or partnership if they are engaged in a unitary business.

16. Minor modifications are made to subsection (b)(1) to provide clarity. The reference to "combined reporting group" is deleted and moved and a reference to "for purposes of apportioning business income" is added. When the apportioning trade or business is operated within a combined reporting group, then all taxpayer members must elect.

> (b) Electing the Single-Sales Factor Formula.
>
> (1) To make a single-sales factor formula election permitted by Revenue and Taxation Code section 25128.5 a taxpayer must make an election on a timely filed, original return for the year of the election. ~~In order~~For an election ~~by a combined reporting group~~ to be effective for purposes of apportioning the business income of a combined reporting group, each taxpayer member of the combined reporting group that is subject to taxation under Part 11 of the Revenue and Taxation Code must ~~affirmatively~~ make ~~this~~ the election.

17. Subsection (b)(3) is modified in response to comments received from the public. The modification deletes references to "combined reporting group" and inserts references to "apportioning trade or business" to clarify that an apportioning trade or business may operate in a form other than a combined reporting group. This is necessary because an apportioning trade or business may operate as a single business entity, as a nonunitary division of a business entity, or as a business entity owned by an individual. Rather than limit this regulation to apportioning trades or businesses that operate within a combined reporting group, deleting these references to "combined reporting group" and replacing them with "apportioning trade or business" removes that limitation and provides clarity.

> (3) An apportioning trade or business~~Combined reporting groups~~ that includes one or more qualified business activities may make the single-sales factor election provided the apportioning trade or business ~~combined reporting group~~ does not derive more than 50 percent of its gross business receipts from qualified business activities.

Revenue and Taxation Code section 25128.5, subdivision (a), states in pertinent part that "for taxable years beginning on or after January 1, 2011, any apportioning trade or

business, *other than an apportioning trade or business described in subdivision (b) of Section 25128*, may make an irrevocable annual election on an original timely filed return . . . ." (Emphasis added.) Revenue and Taxation Code section 25128, subdivision (b), states,

> (b) If an apportioning trade or business derives more than 50 percent of its "gross business receipts" from conducting one or more qualified business activities, all business income of the apportioning trade or business shall be apportioned to this state by multiplying business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

Subsection (b)(3) explains in the first two examples when a corporation and when a combined reporting group may make the single-sales factor formula election when some of the gross business receipts are from qualified activities. Further guidance is provided in a third example added to explain under what circumstances an apportioning trade or business operating as a partnership partially engaged in qualified business activities may use the single-sales factor formula. The further guidance is necessary because, in response to comments received, the regulation now encompasses elections made by entities other than corporate combined reporting groups, and an example of the application of the rules to entities other than corporations provides added clarity.

The example involves an apportioning trade or business operating as a partnership. The partnership derives less than 50 percent of its gross business receipts from qualified business activities and is owned by two nonunitary corporations. Because 50 percent or less of the gross business receipts are from qualified business activities, the apportioning trade or business operating in the partnership may use the single-sales factor formula to determine the California source income for the nonunitary partners.

<u>Example 3: Partnership P conducts an apportioning trade or business and is owned 65 percent by Corporation W and 35 percent by Corporation T. Partnership P derives less than 50 percent of its gross business receipts from an extractive business activity. Partnership P, Corporation T, and Corporation W are not unitary with each other. As a result, Corporation W and Corporation T may not independently decide whether to make a single-sales factor method election for their distributive share items of income from the nonunitary Partnership P. However, Partnership P may use the single-sales factor formula to determine California source income for Corporation W and Corporation T on Part B of schedule R-1 of form 565 using the Partnership P factor(s) because Partnership P's separate apportioning trade or business derives less than 50 percent of its gross business receipts from a qualified business activity.</u>

18. Subsection (b)(4)(A) is deleted as unnecessary. Whether a member of the combined reporting group is subject to taxation under Part 11 of the Revenue and Taxation Code during the taxable year will be known at the time of the annual election at the end of the taxable year, so a member of the combined reporting group that becomes subject

to taxation under Part 11 of the Revenue and Taxation Code during the taxable year may be included in the return at that time and will automatically be subject to any single-sales factor formula election made by members of the combined reporting group. No deemed election is necessary

~~(A) If a corporation that is a member of a combined reporting group is not itself subject to taxation under Part 11 of the Revenue and Taxation Code in the year for which the single-sales factor formula election is made, but subsequently becomes subject to taxation under Part 11 of the Revenue and Taxation Code, that corporation shall be deemed to have elected with the other taxpayer members of the combined reporting group.~~

19. An example (Example 4) is added to subsection (b)(5), "Election following forced de-combination." This example is needed to provide guidance regarding when the single-sales factor formula may be used in the context of a partnership with a corporate partner determined at audit to not be unitary with the partnership. The example explains that the same period of time is available for the single-sales factor formula to be used to determine the California source income of the nonunitary corporate partner as is allowed in a fact pattern involving all corporations.

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Corporation B determines that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4. Corporation A determines that its apportioning trade or business is not unitary with Partnership X. Partnership X determines the California source income of Corporation A using the single-sales factor formula as properly indicated on Part B of schedule R-1 of forms 565 for Years 1 through 4. Corporation A makes no election for its separate apportioning trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2, with a determination dated July 15 of Year 6. Corporation B and Partnership X may file amended returns for Years 1 through 4 by no later than September 15 of Year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula and Partnership X's factors. Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15, 2006 and may use the single-sales factor formula to determine the California source income of Corporation B on a timely filed original Part B of schedule R-1 of form 565 for that year.

20. Subsection (b)(6) is modified to delete the reference to Revenue and Taxation Code section 25128, subdivision (d)(6).

(6) A taxpayer that is engaged in more than one apportioning trade or business ~~as defined in Revenue and Taxation Code section 25128, subdivision (d)(6),~~ may make a separate election for each apportioning trade or business.

Revenue and Taxation Code section 25128, subdivision (d)(6), states,

(6) "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors.

The reference to Revenue and Taxation Code section 25128, subdivision (d)(6), is deleted because it includes references to Section 25101, which includes the language, "When the income of a taxpayer subject to the tax imposed under this part . . . ." Apportioning trade or businesses that operate in partnerships, sole proprietorships, limited liability companies treated as partnerships, and qualified Subchapter S subsidiaries are not subject to tax imposed under Part 11 of the Revenue and Taxation Code and are not required to file a form 100 with the state of California. Accordingly, the reference to Revenue and Taxation Code section 25128, subdivision (d)(6), is deleted so that the single-sales factor formula may be used by all apportioning trades or businesses.

An example (Example 1) is moved from subsection (c)(1) to subsection (b)(6) because subsection (c)(1) is deleted as redundant with subsection (b)(6). The text of the example is provided below with modifications indicated by double underlining. The term "apportioning trade or business" is used instead of "unitary business" to be consistent with Revenue and Taxation Code section 25128.5. The term "combined reporting group" is used instead of "unitary group" to be more precise. A "combined reporting group" is the group after any water's-edge election. It is important to use this term because a foreign corporation that is not a member of a combined reporting group due to a water's-edge election may be unitary with the other members of the combined reporting group. Changing the term from "unitary group" to "combined reporting group" eliminates that ambiguity. Other words are added for clarification.

Example 1: Corporations A and B are taxpayers and are affiliated with each other, and are also affiliated with non-taxpayer Corporations C, D, E, F, G, H, and I. Corporations A, C, D, and G are engaged in one apportioning trade or ~~unitary~~ business and form a combined reporting group, Group X. Corporations B, E, F, H, and I are engaged in another separate apportioning trade or ~~unitary~~ business and form a combined reporting group, Group Y. Since both Corporations A and B are members of a combined reporting group that includes at least one California taxpayer~~s~~, ~~either~~ each may independently elect to file on a single-sales factor formula basis for purposes of apportioning business income of ~~with~~ their respective ~~unitary~~ combined reporting group~~s~~. It is not necessary for both Corporations A and B to make the same election, even though they are members of the same group of affiliated corporations. Corporation A, filing a group return

for Group X, may make a single-sales factor formula election for Group X. Corporation B, filing a group return for Group Y, is not required to make a single-sales factor formula election.

Four examples are added (Examples 2, 3, 4, 5) to subsection (b)(6) to provide clarity for how the single-sales factor formula election operates when there is a partnership owned by a nonunitary corporate partner, when there are disregarded entities operating separate apportioning trade or businesses as divisions of a nonunitary corporate owner, when there are disregarded entities that are owned by a unitary corporate owner operating within a combined reporting group, and when there are qualified Subchapter S subsidiaries with some unitary and some not unitary with the S corporation parent. The examples provide guidance on whether an independent single-sales factor election may be made in each fact pattern. All of these examples are necessary to provide guidance on how to apply the regulation to these entities.

Example 2 provides guidance for when a corporation owns two separate apportioning trade or businesses that operate within two partnerships where the corporation is not unitary with either of the partnerships and the partnerships are not unitary with each other. The single-sales factor formula may be used at the partnership level to determine the California source income of the nonunitary partner. Since the two partnerships owned by the nonunitary partner operate independent apportioning trades or businesses not unitary with each other, each partnership may make independent single-sales factor formula elections to determine the California source income of the nonunitary corporate partner.

> Example 2: Corporation W is a taxpayer that owns 50 percent of two separate apportioning trades or businesses, Partnership J and Partnership K, but is not unitary with either partnership. Partnership J determines the California source income of Corporation W using the single-sales factor method on a timely filed original return on Part B of schedule R-1 of form 565. Partnership K makes no election and uses the standard three-factor formula to determine the California source income of Corporation W. Corporation W makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula.

Example 3 provides guidance for when a corporation owns disregarded entities that operate distinct apportioning trades or businesses that are not unitary with each other, are not unitary with the corporate owner, and operate as divisions of the corporate owner. The example illustrates that each independent apportioning trade or business operating in each of the disregarded entities may determine the California source income of the corporate owner using the single-sales factor formula. It is not required that all of the disregarded entities make the same single-sales factor formula election because they are not unitary with each other and therefore do not comprise one apportioning trade or business.

> Example 3: Corporation P is a taxpayer that is the single owner of three limited liability companies, Q, R, and S that are each disregarded entities for tax

purposes and operate three distinct apportioning trades or businesses. P, Q, R, and S are not unitary with one another. Q and R determine the California source income of Corporation P using the single-sales factor formula on timely filed original information returns on Part B of schedule R-1 of form 568. S makes no election and determines the California source income of Corporation P using the standard three-factor formula on Part A of schedule R-1 of form 568. Corporation P makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula on Part A of schedule R-1 of form 100.

Example 4 provides guidance for when a corporation owns disregarded entities that are unitary with the corporate owner. In that situation the income and factors of the disregarded entities are added to those of the corporate owner and a single-sales factor formula election may be made by the corporation to apportion the income of the corporate owner's unitary business. No separate election by the disregarded entity is possible because it is not a separate apportioning trade or business, but rather is a unitary division of the trade or business of the corporation.

Example 4: Same facts as Example 3 except that Corporation P and the disregarded limited liability companies Q, R, and S are unitary. The combined reporting group includes Corporation P (Q, R, and S), Corporation A and Corporation B filing a group return for Group P. Group P makes a single-sales factor formula election on its timely filed original group return. Since Q, R, and S are disregarded entities operating as divisions of Corporation P and are unitary with each other and Corporations P, A, and B, the income and factors of Q, R, and S are added to those of Corporations P, A, and B, and the single-sales factor formula is used to apportion the income of Group P.

Example 5 provides guidance for when a corporation has elected to be treated as an S corporation and owns qualified Subchapter S subsidiaries that are disregarded entities not unitary with each other or with the S corporation owner. The S corporation may elect to use the single-sales factor formula for its own apportioning trade or business that includes the income and factors of a unitary Subchapter S subsidiary. Each of the qualified Subchapter S subsidiaries that is not unitary with the S corporation owner may use the single-sales factor formula to determine the California source income of the S corporation owner. The S corporation and the nonunitary qualified Subchapter S subsidiary are not required to make the same election because they do not comprise a single apportioning trade or business.

Example 5: Corporation T has elected to be an S corporation. It wholly owns Corporations U, V, and W, each of which satisfies the requirements to be a qualified Subchapter S subsidiary and, pursuant to an election by T, are treated as disregarded entities. T is unitary with W, while T, U and V are not unitary with one another and each operates a separate apportioning trade or businesses. U and V determine the California source income of Corporation T using the single-sales factor formula on a timely filed original return, form 100S filed by Corporation T, with the election indicated on Part B of schedule R-1 attached to

schedule QS. Corporation T makes no single-sales factor formula election. Because W is unitary with T and T made no election, W may not determine Corporation T's California source income using the single-sales factor formula. Corporation T does the following: (1) apportions the business income from its separate apportioning trade or business using the standard three-factor formula, (2) adds the income and factors of unitary W to its own income and factors, and (3) adds the California source income from the separate apportioning trades or businesses of U and V as determined using the single-sales factor formula with U and V's sales factors.

21. Subsection (b)(7) is modified to add references to the forms that partnerships, limited liability companies, qualified Subchapter S subsidiaries, individuals, and nonresident individuals must use to make a single-sales factor formula election to determine California source income for nonunitary partners, nonunitary owners, individuals, or nonresident individuals. In addition, the word "of" is changed to "attached to."

(7) Validity of Election. An election under this regulation will be considered valid if the following conditions are satisfied:

(A) The tax is computed in a manner consistent with the single-sales factor formula election, and

(B) A written notification of election is filed with the return on Part B of schedule R-1 ~~of~~ attached to form 100 (S Corporations file a form 100S, and water's-edge corporations file a form 100W), form 565 (for nonunitary partnerships), form 568 (for nonunitary limited liability companies), schedule QS (for nonunitary qualified Subchapter S subsidiaries), form 540 (for individuals), or form 540NR (for nonresident individuals).

22. Subsection (c)(1) is deleted as redundant with subsection (b)(6) and the example is moved to subsection (b)(6) at Example 1. The example is modified as indicated under number 20 above.

~~(1) Affiliated corporations not engaged in the same unitary business. A group of affiliated corporations that are engaged in more than one unitary business may make a single-sales factor formula election with respect to one or more of the businesses, but need not elect for all of its businesses.~~

~~Example: Corporations A and B are California taxpayers and are affiliated with each other and with Corporations C, D, E, F, G, H, and I. Corporations A, C, D, and G are engaged in one unitary business, Group X. Corporations B, E, F, H, and I are engaged in another separate unitary business, Group Y. Since both Corporations A and B are California taxpayers, either may elect to file on a single-sales factor formula basis with their respective unitary group. It is not necessary for both Corporations A and B to make the same election, even though they are members of the same group of affiliated corporations. Corporation A, filing a group return for Group X, may make a single sales factor formula election for Group X.~~

~~Corporation B, filing a group return for Group Y, is not required to make a single sales factor formula election.~~

23. Subsection (c)(2) is renumbered to be subsection (c)(1) and is modified. The phrase "to the extent owned by corporations" is added to clarify that this subsection does not address partnerships to the extent owned by individuals. A sentence is added to clarify that a partnership may use the single-sales factor formula to determine the California source income of nonunitary partners. This section is necessary to provide further guidance regarding partnerships owned by nonunitary partners, as an apportioning trade or business may operate within a partnership owned by a nonunitary corporate partner and this was not addressed in the earlier version of the regulation. A sentence was added to subsection (c)(1) in response to comments received by the public. This sentence allows the single-sales factor formula election to be made at the partnership level to determine the California source income of the nonunitary corporate partner.

> (1) Partnerships to the extent owned by corporations. Corporations that elect single-sales factor formula apportionment must use the single-sales factor formula for distributive share items of income and factors from unitary partnerships. A partnership may make a single-sales factor formula election on Part B of schedule R-1 of form 565 or form 568 to determine California source income for its nonunitary partners.

Three new examples are added and two examples are deleted. The following two examples are deleted so that the new examples can clarify that nonunitary partnerships may use the single-sales factor formula at the partnership level.

> ~~Example 1. Corporation A is a taxpayer. Corporation A and B are members of a combined reporting group. Corporation A owns 50 percent of the unitary Partnership Y. Accordingly, 50 percent of Partnership Y's income and factors are included in Corporation A and Corporation B's combined report. Corporation A makes a single sales factor formula election. Corporation A's sales factor will include the California sales of Partnership Y to the extent of its ownership interest. Partnership Y's payroll and property will be disregarded for apportionment purposes consistent with Corporation A's election.~~
>
> ~~Example 2. Same facts as Example 1 except that Corporation A owns 50 percent of the nonunitary Partnership Z instead of a 50 percent interest in unitary Partnership Y. Pursuant to California Code of Regulations section 25137-1, subsection (g), Corporation A's distributive share of Partnership Z's income is treated as income from a separate trade or business and Corporation A's single sales factor election does not apply to determining Partnership Z's California sourced income. Partnership Z's California source income is separately determined utilizing the rules contained in California Code of Regulations, section 25137-1, subsection (g).~~

Example 1 is added to illustrate when and where a single-sales factor formula election may be made when there is a partnership owned by two corporate partners, one

unitary and one not unitary with the partnership. For the unitary corporate partner, the election is made at the partner level with the distributive share items of income and factors from the partnership combined with those of the corporate partner. For the nonunitary corporate partner, the election is made at the partnership level to determine the California source income of the nonunitary partner.

> Example 1: Partnership Y is owned 50 percent by Corporation A, which is a member of a combined reporting group, Group A, and 50 percent by Corporation B, which is a member of a combined reporting group, Group B. Partnership Y is unitary with Group A but not with Group B. If Group A makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from Partnership Y, adding 50 percent of the sales factor numerator and denominator of Partnership Y to those of Group A and adding 50 percent of total business income of Partnership Y to that of Group A. Partnership Y may make a single-sales factor formula election or may choose to not elect and remain on the three-factor formula to determine the California source income for Corporation B.

Example 2 is added to illustrate when and where a single-sales factor formula election may be made when there is a limited liability company treated as a partnership that has several owners, each operating independent apportioning trades or businesses, some unitary and some not unitary with the limited liability company. The corporate partner that is unitary with the limited liability company may make a single-sales factor formula election and, if it does so, must use the single-sales factor formula for its distributive share of items of income and factors from the limited liability company. The limited liability company may use the single-sales factor formula to determine the California source income for each of the nonunitary corporate partners. Since the two nonunitary corporate partners are not unitary with each other, they are instead in separate apportioning trades or businesses and may make separate elections to apportion their own income.

> Example 2: A limited liability company M has three owners and has made no election for its classification for tax purposes so by default M is treated as a partnership. Each of the three owners of M operate an apportioning trade or business in addition to that operated by M. M is owned 25 percent by Corporation A, 25 percent by Corporation B, and 50 percent by Corporation C. M is unitary with Corporation C, but not with Corporations A or B. If Corporation C makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from M, adding 50 percent of the sales factor numerator and denominator of M to its own and adding 50 percent of total business income to its own total business income. M may make a single-sales factor method election to determine the California source income for Corporations A or B. Corporations A and B may independently make single-sales factor formula elections for their own separate apportioning trades or businesses that do not include M.

Example 3 illustrates when and where a single-sales factor formula election may be made when there are tiered pass-through entities, with some unitary and some not unitary. As a general rule, when there is a pass-through entity, the ability to make a single-sales factor formula election moves to the next ownership level if the pass-through is unitary with the next-level owner and the next-level owner is not itself a pass-through entity. If the next-level owner is itself a pass-through entity, the election moves up to further levels of unitary owners until reaching a unitary corporate owner where the election may be made, including the distributive share items of income and factors from all the preceding pass-through entities. If the pass-through entity is not unitary with its owner (whether the owner is a corporation or a pass-through entity), then the election may be made at the pass-through entity level to determine the California source income for the nonunitary owner using the income and factors of the pass-through entity which includes the distributive share items of income and factors from all the preceding unitary pass-through entities.

> Example 3: Partnership X operates an apportioning trade or business and is owned 50 percent by a limited liability company (R) taxed as a partnership and 50 percent by a limited liability company (T) that has elected to be taxed as a corporation. All three business entities X, R, and T, are unitary. R is owned 5 percent by nonunitary Corporation A, 85 percent by unitary Corporation B, and 10 percent by nonunitary limited liability company S taxed as a partnership. The combined reporting group of X, R, T, and Corporation B is Group Y. The 50 percent distributive share of income and factors from X flows through to R and T. To determine the California source income for the 5 percent distributive share items of income for nonunitary Corporation A, the single-sales factor formula may be used at the R level by R on Part B of schedule R-1 of form 568 using R's factors. The single-sales factor formula may also be used by unitary Corporation B which may elect to use the single-sales factor formula on Part B of schedule R-1 of form 100 if the same election is made by all members of Group Y. Corporation B would add to its own income and factors its 85 percent distributive share of income and factors from R (which would include R's 50 percent distributive share of income and factors from X) and the combined factors and income would be used on Corporation B's schedule R-1 of form 100 or Group Y's group return. To determine the California source income for the 10 percent distributive share items of income for nonunitary S, the single-sales factor formula may be used at the R level on Part B of schedule R-1 of form 568 using R's factors.

24. Subsection (c)(2) is added to reflect comments received from the public regarding the application of the regulation to non-corporate apportioning trades or businesses. The subsection is necessary to explain that the single-sales factor formula may be used by sole proprietorships and partnerships to the extent owned by nonresident individuals. Examples are provided.

> (2) Nonresidents.
>
> (A) Sole Proprietorships. A nonresident individual who is a sole proprietor of a business that engages in activities partly within and partly without the

state, as provided in California Code of Regulations section 17951-4, subsection (c)(2), may determine California source income using the single-sales factor formula.

Example 1: Beth Johnson is a nonresident and is the single owner of a sole proprietorship that operates an apportioning trade or business engaged in activities within and without California. Beth Johnson may use the single-sales factor formula on Part B of schedule R-1 for purposes of sourcing her income from the sole proprietorship.

Example 2: John Smith is a nonresident and is the single owner of a limited liability company that operates an apportioning trade or business engaged in activities within and without California. The limited liability company is treated as a disregarded entity for tax purposes. John Smith may make the single–sales factor formula election on Part B of schedule R-1 of form 568 for purposes of sourcing the limited liability company's income.

(B) Partnerships to the extent owned by individuals. A nonresident individual who is a partner in a partnership that engages in activities partly within and partly without the state may determine California source income, as provided in California Code of Regulations section 17951-4, subsection (d)(1), using the single-sales factor formula on Part B of schedule R-1 of form 565, but if the partnership does elect to use the single factor formula, the partnership must use the single-sales factor formula to determine California source income for all nonresident partners.

Example: Janet Jones and Bruce Johnson are nonresidents and are partners in an apportioning trade or business that operates as Partnership X. Each of the partners owns 50 percent of the partnership. Partnership X may elect to use the single-sales factor formula on Part B of schedule R-1 of form 565 to determine the California source income of the partners, but if Partnership X uses the single-sales factor formula, it must do so for both Janet Jones and for Bruce Johnson.

25. There are minor modifications made to the language that can be reviewed in the full proposed draft. These include consistently referring to Revenue and Taxation Code sub-parts as "subdivisions" and California Code of Regulation sub-parts as "subsections," deleting references to "paragraph" after "subsection," changing "who" to "which" when the reference is to a corporation, changing the language for a series of years to be more concise, deleting unnecessary words, changes in punctuation for uniformity, and changes to numbering to accommodate added paragraphs,

These nonsubstantial or sufficiently related changes are being made available to the public for the 15-day period required by Government Code section 11346.8, subdivision (c), and Section 44 of Title 1 of the California Code of Regulations. Written comments regarding these changes will be accepted until 5:00 p.m. on May 31, 2011.

A copy of the proposed amendments is being sent to all individuals who requested notification of such changes, as well as those who attended the hearing and those who commented orally or in writing, and will be available to other persons upon request. All inquiries and written comments concerning this notice should be directed to Colleen Berwick (916) 845-3306, FAX (916) 845-3648, E-Mail: colleen.berwick@ftb.ca.gov, or by mail to the Legal Division, Attn: Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. This notice and the proposed amendments and adoptions will also be made available at the Franchise Tax Board's website at http://www.ftb.ca.gov/.

SUMMARY OF COMMENTS RECEIVED DURING 15-DAY NOTICE
PERIOD FOR NOTICE ISSUED ON MAY 16, 2011,
RESPONSES AND RECOMMENDATIONS
Proposed Regulation section 25128.5

Comments from Alan Bollinger dated May 31, 2011

1. Errata: Certain errors were discussed.

   a. Subsection (b)(4)(C) at the Example on pages 7-8:
      - Line 8 should read "...taxpayers begins on July 1, 2011 and ends on **December 31, 2011**. The business..."
      - Line 18 should read "...test will be based on a comparison of the business assets for the **first** six-month..."

   Response:

   Changes were made to the Example at subsection (b)(4)(C) so that it reads as follows:

   Example: Corporations A, B, C, and D are California taxpayer members of a combined reporting group. Corporations A, B, and C are calendar year taxpayers and are included in a group return. Their return filed for taxable year ending December 31, 2011 uses the single-sales factor formula. Conversely, Corporation D has a fiscal year end on June 30th. The return Corporation D files for the year end of June 30, 2012 uses the standard formula. The first common six-month period for taxable years beginning on or after January 1, 2011 for all of the taxpayers begins on July 1, 2011, and ends on December 31, 2011 ~~June 30, 2012~~. The business assets for the last six months of 2011 for electing Corporations A, B, and C are compared to the business assets of non-electing Corporation D for the same time period. If the business assets of electing Corporations A, B, and C are greater than the business assets of non-electing Corporation D for the common six-month period; then Corporation D is deemed to have elected the single-sales factor formula for apportionment. Conversely, if the business assets of non-electing Corporation D are greater than the business assets of Corporations A, B, and C for the common six-month period, there is no single-sales factor formula election for Corporations A, B, or C. For all taxable years thereafter, the business assets test will be based on a comparison of the business assets for the first ~~last~~ six-month period of Corporation D's fiscal year.

   b. Subsection (b)(5)(A) on page 8, delete the reference to subsection "(A)" since this is a stand-alone provision.

   Response:

The reference to subsection "(A)" was deleted.

c. Subsection (b)(5)(A) at Example 4 on page 9 should be revised as follows:
   - Line 15 should state, "...September **13** (60 days from the date of audit determination of year 6 to ..."
   - Line 22 should state, "...Of October 15, **Year 6** and may use the single-sales factor formula to determine..."

Response:

The proposed corrections were made and the subsection (b)(5)(A) as corrected reads as follows:

(5) Election following forced de-combination.

~~(A)~~ A taxpayer that is subsequently found to not be a member of the combined reporting group pursuant to a Franchise Tax Board audit determination (represented by a notice of additional tax proposed to be assessed, a notice of proposed overpayment, notice of action on a claim for refund, or a letter from the tax auditor regarding a computational effect which does not result in a current year adjustment [e.g., a computation of net operating loss carryover]) may elect to use the single-sales factor formula on an amended return that will be treated as an original return for the purpose of the single-sales factor formula election. The election should ordinarily be made during the course of the audit examination so that the results of that election can be reflected in the applicable notices related to the examination. Except for claims for refund, this election after de-combination must be made no later than 60 days after the date of the applicable notice. This election may be made for each taxable year beginning with the year of de-combination through 60 days after the date of the applicable notice. The Franchise Tax Board may extend such 60-day period for good cause, not to exceed 180 days. In the case of a claim for refund for the entity that was erroneously included in the combined reporting group, a request for the single-sales factor formula election must be made in the claim itself or presented before issuance of the notice of action on the claim. Information to substantiate the effect of the election shall be provided to the Franchise Tax Board within a reasonable time after an election under this subsection is made.

Example 1: Corporations A, B, and C are included in a group return for calendar Years 1 through 6 that includes a single-sales factor formula election. On June 15 of Year 7 the Franchise Tax Board makes an audit determination that Corporation C was erroneously included in the combined report for every year. Corporation C must make the single-sales factor formula election for <u>any of the</u> Years 1 through 6 by August 15 of Year 7. Thereafter,

Corporation C may make the single-sales factor formula election on its timely filed original returns.

Example 2: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1 through 6 on December 26 of Year 7. There is no valid single-sales factor election for Years 1 through 6 because the election was made more than 180 days after the audit determination on June 15 of Year 7.

Example 3: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1 through 6 on September 10 of Year 7. There is a valid single-sales factor election for Years 1 through 6 provided Corporation C successfully shows good cause for electing more than 60 days after the audit determination of June 15 of Year 7.

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Corporation B determines that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4. Corporation A determines that its apportioning trade or business is not unitary with Partnership X. Partnership X determines the California source income of Corporation A using the single-sales factor formula as properly indicated on Part B of schedule R-1 of forms 565 for Years 1 through 4. Corporation A makes no election for its separate apportioning trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2, with a determination dated July 15 of Year 6. Corporation B and Partnership X may file amended returns for Years 1 through 4 by no later than September 13~~5~~ (60 days from the date of audit determination) of Year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula and Partnership X's factors. Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15~~, 2006~~ of Year 6 and may use the single-sales factor formula to determine the California source income of Corporation B on a timely filed original Part B of schedule R-1 of form 565 for that year.

2. Clarification: Certain suggestions were made for purposes of clarification to different subsections.

   a. Subsection (b)(3) at page 5 should have an additional example as follows:

Example 4: Same facts as Example 1, except that general corporations B and C are unitary partners in Partnership F that conducts a banking or financial business activity. Group X now receives more than 50 percent of its gross business receipts form the activities of Corporation A and the distributive share from Partnership F. Group X may not make the single-sales factor formula election.

Response:

A new example was added as follows:

Example 4: Same facts as Example 1, except that general corporations B and C are unitary partners in Partnership F that conducts banking and financial activity as a part of the combined reporting group, Group X. The distributive share of gross business receipts from Partnership F combined with the business receipts from Corporation A cause Group X to have more than 50 percent of its gross business receipts from qualified business activities. Group X may not make the single-sales factor formula election.

b. Subsection (b)(5)(A) at Example 1 on page 8 should be modified at line 6 so that it states, "election for **any of the** Years 1 through 6 by August 15 of Year 7. Thereafter, ..."

Response:

Subsection (b)(5)(A) at Example 1 on page 8 was modified so that it reads as follows:

Example 1: Corporations A, B, and C are included in a group return for calendar Years 1 through 6 that includes a single-sales factor formula election. On June 15 of Year 7 the Franchise Tax Board makes an audit determination that Corporation C was erroneously included in the combined report for every year. Corporation C must make the single-sales factor formula election for any of the Years 1 through 6 by August 15 of Year 7. Thereafter, Corporation C may make the single-sales factor formula election on its timely filed original returns.

c. Subsection (b)(5)(A) at Example 4 on page 9 should be modified completely so that it states as follows:

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Partnership X determines the California source income for both of its partners using the single-sales factor formula as properly indicated on part B of schedule R-1 of forms 565 for Years 1 through 4 (Partnership X is unaware of whether any of its partners are unitary). Corporation B determines

that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4. Corporation A determines that its apportioning trade or business is not unitary with Partnership X. Corporation A makes no election for its separate apportioning trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2, with a determination dated July 15 of Year 6. Because Corporation B is found not unitary with Partnership X and due to the original election made by Partnership X, the California source income as reflected on the K-1 to Corporation B is included as part of the audit adjustment proposed by the Franchise Tax Board and this subsection is not operative.

Response:

The proposed example was not included in the proposed regulation because it is not necessary for purposes of clarification and could be misleading by appearing to allow a SSF election to be made at the partnership level for both unitary and nonunitary corporate partners.

d. Subsection (b)(5)(A) at page 9 should be modified by adding an Example 5 as follows:

Example 5: Same facts as Example 4, except that Partnership X did not make a single-sales factor formula election on Part B of schedule R-1 of forms565 for Years 1 through 4. Corporation B and Partnership X may file amended returns for years 1 through 4 no later than September 13 (60 days from the date of audit determination) of year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula an Partnership X's factors. Corporation B must file forms 100X and partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15, Year 6 and may use the single-sales factor formula to determine the California source income of its partners on a timely filed original Part B of schedule R-1 of form 565 for that year.

Response:

This proposed example is similar to the one at Example 4 of subsection (b)(5)(A) and accordingly was not included as redundant.

e. Subsection (c)(1) at page 13, Example 3, should be modified to have limited liability company T owned greater than 50 percent by Corporation B so that it is clear that Group Y meets the unity of ownership requirement.

Response:

Subsection (c)(1), Example 3, was modified as suggested so that it now reads as follows:

> Example 3: Partnership X operates an apportioning trade or business and is owned ~~5~~4<u>0</u> percent by a limited liability company (R) taxed as a partnership and ~~5~~6<u>0</u> percent by a limited liability company (T) that has elected to be taxed as a corporation. All three business entities X, R, and T, are unitary. R is owned 5 percent by nonunitary Corporation A, 85 percent by unitary Corporation B, and 10 percent by nonunitary limited liability company S taxed as a partnership. The combined reporting group of X, R, T, and Corporation B is Group Y. The ~~50 percent~~ distributive share<u>s</u> of income and factors from X flows through to R and T. To determine the California source income for the 5 percent distributive share items of income for nonunitary Corporation A, the single-sales factor formula may be used at the R level by R on Part B of schedule R-1 of form 568 using R's factors. The single-sales factor formula may also be used by unitary Corporation B which may elect to use the single-sales factor formula on Part B of schedule R-1 of form 100 if the same election is made by all members of Group Y. Corporation B would add to its own income and factors<u>,</u> its 85 percent distributive share of income and factors from R (which would include R's ~~5~~4<u>0</u> percent distributive share of income and factors from X) and the combined factors and income would be used on Corporation B's schedule R-1 of form 100 or Group Y's group return. To determine the California source income for the 10 percent distributive share items of income for nonunitary S, the single-sales factor formula may be used at the R level on Part B of schedule R-1 of form 568 using R's factors.

f. Subsection (c)(2)(B) at page 15 should be modified. At line 7, insert the word "nonunitary" so that it states, "...determine California source income for all nonunitary nonresident partners."

Response:

The suggested modification was made so that subsection (c)(2)(B) reads as follows:

> (B) Partnerships to the extent owned by individuals. A nonresident individual who is a partner in a partnership that engages in activities partly within and partly without the state may determine California source income, as provided in California Code of Regulations section 17951-4, subsection (d)(1), using the single-sales factor formula on

Part B of schedule R-1 of form 565, but if the partnership does elect to use the single factor formula, the partnership must use the single-sales factor formula to determine California source income for all nonunitary nonresident partners.

g. Subsection (c)(2)(B) should be modified. Change existing Example to "Example 1" and add two additional examples as follows:

Example 2: Professional Partnership Y is comprised of 1,000 partners, 200 of which are resident individuals and 800 of which are nonresident individuals. If Partnership Y makes the single-sales factor formula election on the original part B of schedule R-1 of form 565, all of the nonresident individual partners' California source income is determined using the election and while all of the resident individual partners are taxed on income from all sources, for state tax credit purposes the single-sales factor election must be used.

Example 3: Limited Partnership MF is comprised of two nonresident individual general partners that are unitary (as provided in California Code of Regulations section 17951-4(d)(5)(A)) with MF and other business activities of these two individuals, and 1,000 limited partners that are nonunitary individuals and may or may not all be nonresidents of California. A single-sales factor formula election on the original Part B of schedule R-1 of form 565 is not binding on the two unitary nonresident individual general partners but is binding on all of the limited partners. For those nonresident individual limited partners, the election made by MF determines the California source income to be reported by them. While the resident individual limited partners are taxed on income from all sources, for state tax credit purposes the election made by MF must be used.

Response:

Assuming the commentator is referring to other state tax credits (OSTCs), there is no need to provide the examples suggested. Revenue and Taxation Code section 18001, subdivision (c) provides that in computing the OSTC the phrase “income derived from sources within that state” shall be determined through the use of the nonresident sourcing rules for determining income from sources within this state. Therefore, the regulation, by providing extensive guidance regarding nonresidents and the use of the election, already provides ample guidance for OSTCs as well. There is no need for separate examples, it would be duplicative. No change to the regulation is necessary.

NOTE: Second 15 day notice changes are shown in underscores for additions and strikeouts for deletions.

Section 25128.5 is adopted to read:

§ 25128.5. Single-Sales Factor Formula Election.

(a) Definitions. For purposes of this regulation, the following definitions are applicable:

(1) Affiliated corporations. "Affiliated corporations" are corporations related by common ownership.

(2) Apportioning trade or business. "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned because it has income derived from sources within this state and from sources outside this state. An apportioning trade or business can be conducted in many forms, including, but not limited to, the following:

(A) A corporation.

(B) A corporation that is a member of a combined reporting group.

(C) A division of a corporation engaged in a separate trade or business not unitary with the other trades or businesses of the corporation.

(D) A partnership to the extent owned by a corporate partner that is not unitary with the partnership, whether the corporation stands alone or is a member of a combined reporting group.

(E) A partnership to the extent owned by a partner who is an individual who is not a resident of California.

(F) A sole proprietorship that is operated by an individual who is not a resident of California.

(3) Apportionment. "Apportionment" is the means by which the total business income of an apportioning trade or business is assigned to this state under Revenue and Taxation Code sections 25128 through 25137 and section 25141.

(4) Banking or financial business activity. “Banking or financial business activity” means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

(5) Business assets. "Business assets" are assets, including intangible assets, other than stock of a member of the combined reporting group, which are used in the conduct of the business of the combined reporting group or would produce business income to the combined reporting group if the assets were sold.

Business assets are valued at net book value as of the date that electing taxpayers and non-electing taxpayers or non-taxpayers become members of a new combined reporting group. A copy of the taxpayer's valuation of the business assets must be made available when required by the Franchise Tax Board. The Franchise Tax Board may, in its sole discretion, allow an alternative valuation date if it determines that an alternative date would be more appropriate.

(6) Business asset test. The "business asset test" is the mechanism of comparing business assets to determine if members of a combined reporting group are required to use the standard formula under Revenue and Taxation Code section 25128 or the single-sales factor formula under Revenue and Taxation Code section 25128.5 and this regulation.

(7) Combined reporting group. A "combined reporting group" is as defined by California Code of Regulations section 25106.5, subsection (b)(3).

(8) Commencement date. The "commencement date" of a single-sales factor formula election is the first day of the period for which the election is made.

(9) Common Ownership. "Common ownership" exists if:

(A) A parent corporation owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,

(B) Stock cumulatively representing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph (A), or one or more other corporations that satisfy the conditions of this subparagraph.

(10) Corporation. References to “corporation” include a Subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation pursuant to Revenue and Taxation Code sections 23038 or 23038.5.

(11) Disregarded Entity. A "disregarded entity" is an entity described in California Code of Regulations section 23038(b)-2, subsection (a).

(12) Good cause. "Good cause" shall have the same meaning as specified in Treasury Regulation section 1.1502-75(c).

(13) Gross business receipts. "Gross business receipts" is as defined by Revenue and Taxation Code section 25128, subdivision (d)(1).

(14) Group Return. A "group return" is as defined by California Code of Regulations section 25106.5, subsection (b)(13).

(15) Limited liability company. A "limited liability company" is as defined at Revenue and Taxation Code section 17941, subdivision (d).

(16) Member. "Member" is as defined by California Code of Regulations section 25106.5, subsection (b)(10).

(17) Net book value. "Net book value" is equal to an asset's original cost minus depreciation, depletion and amortization. Book value means the amount which an asset is carried on a balance sheet. Depreciation means the systematic write off of the cost of a tangible asset over the asset's useful life. Depletion means the systematic write off of the cost of harvesting or mining a natural resource. Amortization means the systematic write off of the cost of an intangible asset over the asset's useful life. Book value, depreciation, depletion and amortization will be reflected using United States Generally Accepted Accounting Principles (US GAAP). If any member of a combined reporting group does not maintain its books using US GAAP, the Franchise Tax Board may allow an alternative method of valuation of that member's business assets.

(18) New combined reporting group. A "new combined reporting group" is a combined reporting group that is created by a new affiliation of two or more corporations, or by the addition of one or more new members to an existing combined reporting group.

(19) Nonresident. A "nonresident" is as defined in California Code of Regulations section 17014.

(20) Original return. The "original return" is the last return filed on or before the due date (taking extensions into account) regardless of the form on which it is filed or however it may be denominated. A return filed after the due date (taking extensions into account) regardless of the form on which it is filed or however it may be denominated may be an original return, if no other return has been filed, but it would not be a timely filed, original return.

(21) Partnership. A "partnership" is as defined in Revenue and Taxation Code section 17008 and includes entities treated as partnerships as set forth in California Code of Regulations section 23038(b)-3.

(22) Qualified business activities. "Qualified business activities" are as defined in Revenue and Taxation Code section 25128, subdivision (c).

(23) Qualified Subchapter S subsidiary: A "qualified Subchapter S subsidiary" is as defined in Internal Revenue Code section 1361, subsection (b)(3), as incorporated by Revenue and Taxation Code section 23800 and as modified by Revenue and Taxation Code section 23800.5.

(24) Resident. A "resident" is as defined in Revenue and Taxation Code section 17014, subdivision (a), and California Code of Regulations section 17014, subsection (a).

(25) S corporation. An "S corporation" is as defined in Internal Revenue Code sections 1361 and 1362, as modified by Revenue and Taxation Code sections 23800.5 and 23801.

(26) Sole Proprietorship. A "sole proprietorship" is an unincorporated trade or business that is operated by one individual.

(27) Standard formula. The "standard formula" is the three-factor method of apportionment as defined by Revenue and Taxation Code section 25128 and California Code of Regulations section 25128.

(28) Taxpayer. "Taxpayer" means an individual, corporation, or partnership with a requirement to file a California franchise or income tax return.

(29) Taxpayer member. "Taxpayer member" is as defined by California Code of Regulations section 25106.5, subsection (b)(11).

(30) Timely filed. A "timely filed" return is one filed on or before the due date (taking extensions into account).

(31) Unitary. One corporation or partnership is "unitary" with another corporation or partnership if they are engaged in a unitary business.

(32) Unitary business. A “unitary business” consists of those activities required to be included in a combined report pursuant to Revenue and Taxation Code section 25101 and the published cases decided thereunder by the United States Supreme Court, the courts of this State, and the California State Board of Equalization. Activities constitute a "unitary business" if unity of ownership, unity of operation, and unity of use are present, or if the activities carried on within the state contribute to or are dependent upon the activities carried on without the state. California Code of Regulations section 25120, subsection (b), sets forth certain indicia and standards for determining whether activities constitute a single trade or business and are therefore unitary.

(b) Electing the Single-Sales Factor Formula.

(1) To make a single-sales factor formula election permitted by Revenue and Taxation Code section 25128.5, a taxpayer must make an election on a timely filed, original return for the year of the election. For an election to be effective for purposes of apportioning the business income of a combined reporting group, each taxpayer member of the combined reporting group that is subject to taxation under Part 11 of the Revenue and Taxation Code must make the election.

Example: Corporation P, a calendar year California taxpayer, has a subsidiary, Corporation A, which is also a calendar year California taxpayer. Corporation P and Corporation A are members of the same combined reporting group. On its separate timely filed return, Corporation P makes a single-sales factor formula election. Conversely, on its separate timely filed return, Corporation A does not make a single-

sales factor formula election. As a result, neither Corporation P nor Corporation A are deemed to have made a single-sales factor formula election.

(2) An election made on a group return is an election by each taxpayer member included in that group return. However, the election made on the group return will not have any effect if a taxpayer member of the combined reporting group files a separate return in which no election is made, unless subsection (b)(4)(C) applies.

(3) An apportioning trade or business that includes one or more qualified business activities may make the single-sales factor election provided the apportioning trade or business does not derive more than 50 percent of its gross business receipts from qualified business activities.

Example 1: Corporation A is a bank or financial corporation. Corporations B and C are general corporations. Corporation A, B, and C are members of the same combined reporting group, Group X. Group X receives less than 50 percent of its gross business receipts from ~~the~~ qualified banking and financial activities ~~of Corporation A~~. Accordingly, Corporation A may make the single-sales factor formula election along with Group X.

Example 2: Same facts as Example 1, except that Group X receives more than 50 percent of its gross business receipts from ~~the~~ qualified banking and financial activities ~~of Corporation A~~. Corporation A must apportion pursuant to Revenue and Taxation Code section 25128, subdivision (b), and is precluded from making a single-sales factor formula election. Group X may not make the single-sales factor formula election.

Example 3: Partnership P conducts an apportioning trade or business and is owned 65 percent by Corporation W and 35 percent by Corporation T. Partnership P derives less than 50 percent of its gross business receipts from an extractive business activity. Partnership P, Corporation T, and Corporation W are not unitary with each other. As a result, Corporation W and Corporation T may not independently decide whether to make a single-sales factor method election for their distributive share items of income from the nonunitary Partnership P. However, Partnership P may use the single-sales factor formula to determine California source income for Corporation W and Corporation T on Part B of schedule R-1 of form 565 using the Partnership P factor(s) because Partnership P's separate apportioning trade or business derives less than 50 percent of its gross business receipts from ~~a~~ qualified business activit~~y~~es.

Example 4: Same facts as Example 1, except that general corporations B and C are unitary partners in Partnership F that conducts banking and financial activity as a part of the combined reporting group, Group X. The distributive share of gross business receipts from Partnership F combined with the business receipts from Corporation A cause Group X to have more than 50 percent of its gross business receipts from qualified business activities. Group X may not make the single-sales factor formula election.

(4) Deemed Single-Sales Factor Formula or Standard Formula Elections and Non-Elections.

(A) Corporations that are non-electing taxpayers that are subsequently found to be members of a combined reporting group as the result of a Franchise Tax Board audit determination (represented by a notice of additional tax proposed to be assessed, a notice of proposed overpayment, notice of action on a claim for refund, or a letter from the tax auditor regarding a computational effect which does not result in a current year adjustment [e.g., a computation of net operating loss carryover]) shall be deemed to have elected the single-sales factor formula if the value of the total business assets of the electing taxpayer(s) is greater than those of the non-electing taxpayer(s). The commencement date of the deemed single-sales factor formula election shall be the same as the commencement date of the electing taxpayers. If the value of total business assets of the electing taxpayers does not exceed the value of total business assets of the non-electing taxpayers, the single-sales factor formula election of each electing taxpayer is terminated as of the date the non-electing taxpayers are, pursuant to the audit determination, properly included in the same combined reporting group as the electing taxpayers. Non-electing taxpayers may not be deemed to have made a single-sales factor formula election if the Franchise Tax Board audit determination is withdrawn or otherwise overturned. For purposes of applying this paragraph, the business assets of other members of the combined reporting group that are not taxpayers shall not be taken into account.

Example 1: Corporation P is not a California taxpayer. It has two subsidiaries, Corporation A and Corporation B, that are California taxpayers, and another subsidiary, Corporation C, that is not a California taxpayer. Corporations P, A, and C are members of the same combined reporting group. Corporation A makes a single-sales factor formula election on its timely filed return which reflects the apportionment factors and income of Corporations P and C. Corporation B files a separate tax return as a standard formula non-electing taxpayer. Upon Franchise Tax Board audit, Corporation B is determined to be a member of the combined reporting group that includes Corporations A, P, and C. In the year of Corporation A's single-sales factor formula election, Corporation A's business assets are $500 million and Corporation B's business assets are $250 million. Based on the business asset test, Corporation B is deemed to have elected the single-sales factor formula, because Corporation A's business assets are greater than Corporation B's business assets. Corporations P and C's business assets are not taken into account in performing the business assets test, since neither P nor C are California taxpayers.

Example 2: Corporations A, B, and C are taxpayer members of the same combined reporting group. The original timely-filed group return for 2011 that was filed on behalf of each of them includes a single-sales factor election. Corporation D, which is owned by Corporation A, was not considered to be a member of Corporation A, B, and C's combined reporting group for 2011. Corporation D filed its own 2011 California tax return, which did not include a single-sales factor election. During an audit conducted in 2014, the FTB determined that Corporation D was a member of Corporation A, B, and C's combined reporting group for 2011. During 2011, Corporation D's business

assets were greater than Corporation A, B, and C's combined business assets. Consequently, the single-sales factor election that was initially made on behalf of Corporations A, B, and C for 2011 is disregarded. For purposes of determining any proposed assessments relating to 2011 for Corporations A, B, and C, the FTB will recalculate the combined reporting group's business income using the standard formula.

(B) If a taxpayer member of a combined reporting group files a separate return based on the standard formula, while other taxpayer members of the combined reporting group included in a group return file based on the single-sales factor formula, the business asset test will determine which method must be used for all taxpayer members of the combined reporting group.

Example 1: Corporations A, B, C, and D are California taxpayer members of a combined reporting group. Corporations A, B, and C file a group return using the single-sales factor formula. Conversely, Corporation D files a separate return using the standard formula. Pursuant to the business asset test, because the business assets of the electing Corporations A, B, and C are greater than the business assets of the non-electing Corporation D, Corporation D is deemed to have elected the single-sales factor formula.

Example 2: Same facts as Example 1, except that the business assets of Corporation D are greater than the combined business assets of Corporations A, B, and C. There is no single-sales factor formula election for Corporations A, B and C.

(C) When taxpayer members of a combined reporting group file separate returns because their relative tax years end on different dates and some taxpayer members have elected the single-sales factor formula, while others have not, for purposes of conducting the business asset test, the business assets for the electing and non-electing taxpayers will be compared for each common six-month period that occurs after January 1, 2011. Thereafter, the business assets test will be applied to the same common six-month period. The Franchise Tax Board may, in its sole discretion, allow an alternative method if it determines an alternative method would be more appropriate.

Example: Corporations A, B, C, and D are California taxpayer members of a combined reporting group. Corporations A, B, and C are calendar year taxpayers and are included in a group return. Their return filed for taxable year ending December 31, 2011 uses the single-sales factor formula. Conversely, Corporation D has a fiscal year end on June 30th. The return Corporation D files for the year end of June 30, 2012 uses the standard formula. The first common six-month period for taxable years beginning on or after January 1, 2011 for all of the taxpayers begins on July 1, 2011, and ends on December 31, 2011 ~~June 30, 2012~~. The business assets for the last six months of 2011 for electing Corporations A, B, and C are compared to the business assets of non-electing Corporation D for the same time period. If the business assets of electing Corporations A, B, and C are greater than the business assets of non-electing

Corporation D for the common six-month period; then Corporation D is deemed to have elected the single-sales factor formula for apportionment. Conversely, if the business assets of non-electing Corporation D are greater than the business assets of Corporations A, B, and C for the common six-month period, there is no single-sales factor formula election for Corporations A, B, or C. For all taxable years thereafter, the business assets test will be based on a comparison of the business assets for the first ~~last~~ six-month period of Corporation D's fiscal year.

(5) Election following forced de-combination.

~~(A)~~ A taxpayer that is subsequently found to not be a member of the combined reporting group pursuant to a Franchise Tax Board audit determination (represented by a notice of additional tax proposed to be assessed, a notice of proposed overpayment, notice of action on a claim for refund, or a letter from the tax auditor regarding a computational effect which does not result in a current year adjustment [e.g., a computation of net operating loss carryover]) may elect to use the single-sales factor formula on an amended return that will be treated as an original return for the purpose of the single-sales factor formula election. The election should ordinarily be made during the course of the audit examination so that the results of that election can be reflected in the applicable notices related to the examination. Except for claims for refund, this election after de-combination must be made no later than 60 days after the date of the applicable notice. This election may be made for each taxable year beginning with the year of de-combination through 60 days after the date of the applicable notice. The Franchise Tax Board may extend such 60-day period for good cause, not to exceed 180 days. In the case of a claim for refund for the entity that was erroneously included in the combined reporting group, a request for the single-sales factor formula election must be made in the claim itself or presented before issuance of the notice of action on the claim. Information to substantiate the effect of the election shall be provided to the Franchise Tax Board within a reasonable time after an election under this subsection is made.

Example 1: Corporations A, B, and C are included in a group return for calendar Years 1 through 6 that includes a single-sales factor formula election. On June 15 of Year 7 the Franchise Tax Board makes an audit determination that Corporation C was erroneously included in the combined report for every year. Corporation C must make the single-sales factor formula election for any of the Years 1 through 6 by August 15 of Year 7. Thereafter, Corporation C may make the single-sales factor formula election on its timely filed original returns.

Example 2: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1 through 6 on December 26 of Year 7. There is no valid single-sales factor election for Years 1 through 6 because the election was made more than 180 days after the audit determination on June 15 of Year 7.

Example 3: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1 through 6 on September

10 of Year 7. There is a valid single-sales factor election for Years 1 through 6 provided Corporation C successfully shows good cause for electing more than 60 days after the audit determination of June 15 of Year 7.

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Corporation B determines that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4. Corporation A determines that its apportioning trade or business is not unitary with Partnership X. Partnership X determines the California source income of Corporation A using the single-sales factor formula as properly indicated on Part B of schedule R-1 of forms 565 for Years 1 through 4. Corporation A makes no election for its separate apportioning trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2, with a determination dated July 15 of Year 6. Corporation B and Partnership X may file amended returns for Years 1 through 4 by no later than September 13~~5~~ (60 days from the date of audit determination) of Year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula and Partnership X's factors. Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15~~, 2006~~ of Year 6 and may use the single-sales factor formula to determine the California source income of Corporation B on a timely filed original Part B of schedule R-1 of form 565 for that year.

(6) A taxpayer that is engaged in more than one apportioning trade or business may make a separate election for each apportioning trade or business.

Example 1: Corporations A and B are taxpayers and are affiliated with each other, and are also affiliated with non-taxpayer Corporations C, D, E, F, G, H, and I. Corporations A, C, D, and G are engaged in one apportioning trade or business and form a combined reporting group, Group X. Corporations B, E, F, H, and I are engaged in another separate apportioning trade or business and form a combined reporting group, Group Y. Since both Corporations A and B are members of a combined reporting group that includes at least one California taxpayer~~s~~, ~~-~~each may independently elect to file on a single-sales factor formula basis for purposes of apportioning business income of their respective ~~-~~combined reporting groups. It is not necessary for both Corporations A and B to make the same election, even though they are members of the same group of affiliated corporations. Corporation A, filing a group return for Group X, may make a single-sales factor formula election for Group X. Corporation B, filing a group return for Group Y, is not required to make a single-sales factor formula election.

Example 2: Corporation W is a taxpayer that owns 50 percent of two separate apportioning trade or businesses, Partnership J and Partnership K, but is not unitary with either partnership. Partnership J determines the California source income of Corporation W using the single-sales factor method on a timely filed original return on Part B of schedule R-1 of form 565. Partnership K makes no election and uses the standard three-factor formula to determine the California source income of Corporation W. Corporation W makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula.

Example 3: Corporation P is a taxpayer that is the single owner of three limited liability companies, Q, R, and S that are each disregarded entities for tax purposes and operate three distinct apportioning trade or businesses. P, Q, R and S are not unitary with one another. Q and R determine the California source income of Corporation P using the single-sales factor formula on timely filed original information returns on Part B of schedule R-1 of form 568. S makes no election and determines the California source income of Corporation P using the standard three-factor formula on Part A of schedule R-1 of form 568. Corporation P makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula on Part A of schedule R-1 of form 100.

Example 4: Same facts as Example 3, except that Corporation P and the disregarded limited liability companies Q, R, and S are unitary. The combined reporting group includes Corporation P (Q, R, and S), Corporation A, and Corporation B filing a group return for Group P. Group P makes a single-sales factor formula election on its timely filed original group return. Since Q, R, and S are disregarded entities operating as divisions of Corporation P and are unitary with each other and Corporations P, A, and B, the income and factors of Q, R, and S are added to those of Corporations P, A, and B, and the single-sales factor formula is used to apportion the income of Group P.

Example 5: Corporation T has elected to be an S corporation. It wholly owns Corporations U, V, and W, each of which satisfies the requirements to be a qualified Subchapter S subsidiary and, pursuant to an election by T, are treated as disregarded entities. T is unitary with W, while T, U and V are not unitary with one another and each operates a separate apportioning trade or businesses. U and V determine the California source income of Corporation T using the single-sales factor formula on a timely filed original return, form 100S filed by Corporation T, with the election indicated on Part B of schedule R-1 attached to schedule QS. Corporation T makes no single-sales factor formula election. Because W is unitary with T and T made no election, W may not determine Corporation T's California source income using the single-sales factor formula. Corporation T does the following: (1) apportions the business income from its separate apportioning trade or business using the standard three-factor formula, (2) adds the income and factors of unitary W to its own income and factors, and (3) adds the California source income from the separate apportioning trade or

business of U and V as determined using the single-sales factor formula with U and V's sales factors.

(7) Validity of Election. An election under this regulation will be considered valid if the following conditions are satisfied:

(A) The tax is computed in a manner consistent with the single-sales factor formula election, and

(B) A written notification of election is filed with the return on Part B of schedule R-1 attached to form 100 (S Corporations file a form 100S, and water's-edge corporations file a form 100W), form 565 (for nonunitary partnerships), form 568 (for nonunitary limited liability companies), schedule QS (for nonunitary qualified Subchapter S subsidiaries), form 540 (for individuals), or form 540NR (for nonresident individuals).

(8) Time for making the election.

(A) The election must be made on a timely filed, original return.

Example: Corporation P is not a California taxpayer, but it has three subsidiaries, Corporations A, B, and C that are taxpayers and are part of its unitary business. No single-sales factor formula election is filed prior to the due date (taking extensions into account) for filing a return. After the due date (taking extensions into account), a delinquent original California return is filed with a single-sales factor formula election by Corporation P, stating that it now believes it had nexus in California. Because the election was not made on a timely filed, original return, there is no valid election.

(B) Timely filings which only supplement a previously filed return, or correct mathematical or other errors, shall be considered as incorporating the previously filed return, to the extent not inconsistent, and shall be treated as the original return for purposes of making a single-sales factor formula election. Any timely filings that clearly reflect an intent to withdraw an election made on a previously filed return shall be treated as an original return.

Example 1: Corporation A is a calendar year taxpayer. Its return is due March 15. But if it files its return on or before October 15, an extension is automatically granted to October 15. If it fails to file a return by October 15, no extension exists. Under the paperless extension process, the return is timely if it is filed on or before October 15.

Corporation A files its original return on October 15 of the year. The original return is timely filed, and any single-sales factor formula election contained therein shall be effective for the year for which the return is filed.

Example 2: Same facts as Example 1 except that Corporation A files its original return on May 15 of the year. The original return is timely filed, and any single-sales factor formula election contained therein shall be effective for the year for which the return is filed.

Example 3: Same facts as Example 2 except that Corporation A files a second return on October 15. Under this regulation, Corporation A's original return was filed on October 15. The single-sales factor formula election must be made by that time. If Corporation A's May 15th filing makes a single-sales factor formula election, and the election is withdrawn in the October 15th filing, the election made on May 15th has no effect. If Corporation A's May 15th filing makes a single-sales factor formula election and the October 15th filing is silent as to the single-sales factor formula election but the calculation of the tax due on the return is consistent with making a single-sales factor formula election, then the single-sales factor formula election made in the May 15th filing is incorporated into the October 15th filing, which will be considered as the original return. If Corporation A's May 15th filing does not make a single-sales factor formula election, but a single-sales factor formula election is made on the October 15th filing, Corporation A has made a single-sales factor formula election and the October 15th filing is the original return.

Example 4: Corporation B, a calendar year taxpayer, files a return on February 15. Corporation B's return is treated as being filed on March 15, which is the date the election is considered to have been made. Any return filed after March 15 (the due date of the return) will be considered an amended return.

Example 5: Corporation C, a calendar year taxpayer, has a due date for its return of March 15. It files a return on February 15 and files a second return on March 10. The return filed on March 10 is treated as the original return for the year. The election to file on a single-sales factor formula basis must be made on the March 10 filing to be effective. If Corporation C's February 15 filing makes a single-sales factor formula election and the March 10 filing uses the standard formula and does not make an election, the election made on the February 15 return has no effect. If Corporation C's February 15th filing did not make a single-sales factor formula election and a single-sales factor formula election is made on the March 10th filing, Corporation C has made a single-sales factor formula election.

(c) Miscellaneous Provisions.

(1) Partnerships to the extent owned by corporations. Corporations that elect single-sales factor formula apportionment must use the single-sales factor formula for distributive share items of income and factors from unitary partnerships. A partnership may make a single-sales factor formula election on Part B of schedule R-1 of form 565 or form 568 to determine California source income for its nonunitary partners.

Example 1: Partnership Y is owned 50 percent by Corporation A, which is a member of a combined reporting group, Group A, and 50 percent by Corporation B, which is a member of a combined reporting group, Group B. Partnership Y is unitary with Group A but not with Group B. If Group A makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from Partnership Y, adding 50 percent of the sales factor numerator and denominator of Partnership Y to those of Group A and adding 50 percent of total business income of Partnership Y to that of Group A. Partnership Y may make a single-

sales factor formula election or may choose to not elect and remain on the three-factor formula to determine the California source income for Corporation B.

Example 2: A limited liability company M has three owners and has made no election for its classification for tax purposes so by default M is treated as a partnership. Each of the three owners of M operate an apportioning trade or business in addition to that operated by M. M is owned 25 percent by Corporation A, 25 percent by Corporation B, and 50 percent by Corporation C. M is unitary with Corporation C, but not with Corporations A or B. If Corporation C makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from M, adding 50 percent of the sales factor numerator and denominator of M to its own and adding 50 percent of total business income to its own total business income. M may make a single-sales factor method election to determine the California source income for Corporations A or B. Corporations A and B may independently make single-sales factor formula elections for their own separate apportioning trades or businesses that do not include M.

Example 3: Partnership X operates an apportioning trade or business and is owned ~~5~~4<u>0</u> percent by a limited liability company (R) taxed as a partnership and ~~5~~6<u>0</u> percent by a limited liability company (T) that has elected to be taxed as a corporation. All three business entities X, R, and T, are unitary. R is owned 5 percent by nonunitary Corporation A, 85 percent by unitary Corporation B, and 10 percent by nonunitary limited liability company S taxed as a partnership. The combined reporting group of X, R, T, and Corporation B is Group Y. The ~~50 percent~~ distributive share<u>s</u> of income and factors from X flows through to R and T. To determine the California source income for the 5 percent distributive share items of income for nonunitary Corporation A, the single-sales factor formula may be used at the R level by R on Part B of schedule R-1 of form 568 using R's factors. The single-sales factor formula may also be used by unitary Corporation B which may elect to use the single-sales factor formula on Part B of schedule R-1 of form 100 if the same election is made by all members of Group Y. Corporation B would add to its own income and factors<u>,</u> its 85 percent distributive share of income and factors from R (which would include R's ~~5~~4<u>0</u> percent distributive share of income and factors from X) and the combined factors and income would be used on Corporation B's schedule R-1 of form 100 or Group Y's group return. To determine the California source income for the 10 percent distributive share items of income for nonunitary S, the single-sales factor formula may be used at the R level on Part B of schedule R-1 of form 568 using R's factors.

(2) Nonresidents.

(A) Sole Proprietorships. A nonresident individual who is a sole proprietor of a business that engages in activities partly within and partly without the state, as provided in California Code of Regulations section 17951-4, subsection (c)(2), may determine California source income using the single-sales factor formula.

Example 1: Beth Johnson is a nonresident and is the single owner of a sole proprietorship that operates an apportioning trade or business engaged in activities within and without California. Beth Johnson may use the single-sales factor formula on

Part B of schedule R-1 for purposes of sourcing her income from the sole proprietorship.

Example 2: John Smith is a nonresident and is the single owner of a limited liability company that operates an apportioning trade or business engaged in activities within and without California. The limited liability company is treated as a disregarded entity for tax purposes. John Smith may make the single–sales factor formula election on Part B of schedule R-1 of form 568 for purposes of sourcing the limited liability company's income.

(B) Partnerships to the extent owned by individuals. A nonresident individual who is a partner in a partnership that engages in activities partly within and partly without the state may determine California source income, as provided in California Code of Regulations section 17951-4, subsection (d)(1), using the single-sales factor formula on Part B of schedule R-1 of form 565, but if the partnership does elect to use the single factor formula, the partnership must use the single-sales factor formula to determine California source income for all nonunitary nonresident partners.

Example: Janet Jones and Bruce Johnson are nonresidents and are partners in an apportioning trade or business that operates as Partnership X. Each of the partners owns 50 percent of the partnership. Partnership X may elect to use the single-sales factor formula on Part B of schedule R-1 of form 565 to determine the California source income of the partners, but if Partnership X uses the single-sales factor formula, it must do so for both Janet Jones and for Bruce Johnson.

(3) Changes in affiliation. Elections are made at the end of each taxable year when changes in affiliation are known. When a corporation is acquired by a combined reporting group and becomes unitary mid-year, the taxpayer members of the combined reporting group have the option of electing to use the single-sales factor formula at the end of that taxable year. The income and factors of the acquired entity are not included in the combined report for the portion of the year before acquisition, and the acquired entity must file a return reflecting its income from California sources and has the option of making its own election for that time period, consistent with this regulation. When a combined reporting group sells a corporation, at the end of the year the taxpayer members of the combined reporting group have the option of making a single-sales factor formula election for the group. The combined reporting group does not include the income and factors of the divested entity for the time period after the sale. The divested entity must file its own tax return for the portion of the year after the sale and has the option to make its own single-sales factor formula election for that portion of the year.

Example 1: Corporation X and its unitary subsidiaries are members of a combined reporting group, Group W, which files on a calendar year basis. Corporation X is a member of Group W from January 1 to June 15 of Year 1. The group return filed by Group W includes Corporation X's income and factors for January 1 through June 14 of Year 1. Group W's taxpayers do not elect to use the single-sales factor formula. Corporation X may make its own single-sales factor formula election for the period starting June 15 through December 31 of Year 1.

Example 2: Corporation A and its unitary subsidiaries B and C are calendar year taxpayers and members of a combined reporting group, Group R. Corporation A acquires Corporation X on June 15 of Year 1. For Year 1, a group return is filed on behalf of the members of Group R with a single-sales factor formula election. The single-sales factor formula election applies to Corporation X for June 15 through December 31 of Year 1.

(d) This regulation shall be applicable to taxable years beginning on or after January 1, 2011.

Note: Authority cited: Section 19503, Revenue and Taxation Code.
Reference cited: Sections 25113 and 25128.5, Revenue and Taxation Code.

SUMMARY OF COMMENTS RECEIVED DURING 15-DAY NOTICE PERIOD FOR NOTICE ISSUED ON JUNE 8, 2011, RESPONSES AND RECOMMENDATIONS

Proposed Regulation section 25128.5

Under Government Code section 11346.9, subdivision (a), paragraph (3), the Franchise Tax Board is required to provide "a summary of each objection or recommendation made regarding the specific adoption, amendment, or repeal proposed ..." A large portion of the one comment received during the 15-day Notice period that commenced on June 8, 2011 is not directly related to the specific modifications that were noticed on June 8, 2011. Although it is not required, the Franchise Tax Board is providing a substantive response.

Comments from Alan Bollinger dated June 20, 2011

1. Subsection (b)(3), at page 5, - suggest flipping Examples 3 and 4.

Response:

The changes made to subsection (b)(3) in the 15-day Notice issued on June 8, 2011 were to add Example 4 in its entirety and to add the words "qualified banking and financial" to examples 1 and 2. The requested changes relate to personal preference on whether the unitary example should be first or second. This is not a change required for clarity and hence no modification is warranted.

2. Subsection (b)(5) at Example 4, page 9, states that Partnership X makes the single-sales factor election for Corporation A only and that, after FTB audit, Corporation B and Partnership X can file amended returns so that Partnership X can make a single-sales factor election for Corporation B. First, it would be unusual for the Partnership to know which corporate partners are unitary and which are not. Second, even if the Partnership was told by one or both corporate partners that they were unitary with the Partnership, the Partnership is not going to prepare the K-1s differently for each partner. If the Partnership is eligible to make, and does make, a single-sales factor election and determines the California source amounts to report in column (e) of Schedule K-1, it will likely attach a statement (for Schedule K-1, line 20c) saying that for those partners who have determined they are unitary with the Partnership the California source amounts determined and reported in column (e) of Schedule K-1 should be ignored and the unitary partner should pick up its share of the distributive income and factors at Table 2 and include those amounts in determining the partner's California source income from its unitary trade or business that includes the distributive share from the Partnership.

Response:

The changes made to subsection (b)(5) in the 15-day Notice issued on June 8, 2011 were those changes that were recommended by this same commentator in a comment filed during the 15-day Notice issued on May 16, 2011. None of these concerns were raised by the commentator at that time. Several minor word changes were made and the changes were noticed on June 8, 2011. Subsection (b)(5) addresses election following forced de-combination, a provision that was requested by the public and inserted by FTB in response to that request so that de-combined entities could later make an election. This new comment appears to relate not to the substance of the regulation language but rather to the commentator's views on whether the example is a realistic hypothetical. However, the hypothetical was designed to illustrate when the election can be made following a forced de-

combination, and does not warrant alteration due to the commentators opinion that the facts are not likely to occur as set forth in the example. No change is necessary.

(5) Election following forced de-combination.

A taxpayer that is subsequently found to not be a member of the combined reporting group pursuant to a Franchise Tax Board audit determination (represented by a notice of additional tax proposed to be assessed, a notice of proposed overpayment, notice of action on a claim for refund, or a letter from the tax auditor regarding a computational effect which does not result in a current year adjustment [e.g., a computation of net operating loss carryover]) may elect to use the single-sales factor formula on an amended return that will be treated as an original return for the purpose of the single-sales factor formula election. The election should ordinarily be made during the course of the audit examination so that the results of that election can be reflected in the applicable notices related to the examination. Except for claims for refund, this election after de-combination must be made no later than 60 days after the date of the applicable notice. This election may be made for each taxable year beginning with the year of de-combination through 60 days after the date of the applicable notice. The Franchise Tax Board may extend such 60-day period for good cause, not to exceed 180 days. In the case of a claim for refund for the entity that was erroneously included in the combined reporting group, a request for the single-sales factor formula election must be made in the claim itself or presented before issuance of the notice of action on the claim. Information to substantiate the effect of the election shall be provided to the Franchise Tax Board within a reasonable time after an election under this subsection is made.

Example 1: Corporations A, B, and C are included in a group return for calendar Years 1 through 6 that includes a single-sales factor formula election. On June 15 of Year 7 the Franchise Tax Board makes an audit determination that Corporation C was erroneously included in the combined report for every year. Corporation C must make the single-sales factor formula election for any of the Years 1 through 6 by August 15 of Year 7. Thereafter, Corporation C may make the single-sales factor formula election on its timely filed original returns.

Example 2: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1 through 6 on December 26 of Year 7. There is no valid single-sales factor election for Years 1 through 6 because the election was made more than 180 days after the audit determination on June 15 of Year 7.

Example 3: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1 through 6 on September 10 of Year 7. There is a valid single-sales factor election for Years 1 through 6 provided Corporation C successfully shows good cause for electing more than 60 days after the audit determination of June 15 of Year 7.

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Corporation B determines that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4. Corporation A determines that its apportioning trade or business is not unitary with Partnership X. Partnership X determines the California source income of Corporation A using the single-sales factor formula as properly indicated on Part B of schedule R-1 of forms 565 for Years 1 through 4. Corporation A makes no election for its separate apportioning

trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2, with a determination dated July 15 of Year 6. Corporation B and Partnership X may file amended returns for Years 1 through 4 by no later than September 13 (60 days from the date of audit determination) of Year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula and Partnership X's factors. Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15 of Year 6 and may use the single-sales factor formula to determine the California source income of Corporation B on a timely filed original Part B of schedule R-1 of form 565 for that year.

In general, partnerships are not subject to franchise or income tax, only the individual partners pay franchise or income tax. However, a partnership may conduct an apportioning trade or business, and when this occurs, the income is attributed to the partners and tax liability then accrues to the partner, not the partnership. Even though a partnership does not pay California franchise or income tax, it has certain filing requirements with the State of California, including the form 565, which is an informational return and includes a schedule K-1 for each partner.

This comment addresses the California schedule K-1 that is attached to the form 565 filed by the partnership. The California schedule K-1 starts with distributive share items of income (loss) and deductions as reported on the federal schedule K-1 attached to the form 1065, where there is no apportionment between states, only division between the partners by distributive share. Adjustments are made to those federal numbers for California purposes, and then the amounts are sourced to California as determined in the final column.

The commentator states that it would like to allow a partnership with many partners to file the California schedule K-1 for each partner using the single-sales factor formula regardless of whether the partner is unitary on the basis that (1) the partnership may not know whether the partner is unitary with the partnership, and (2) even if the partnership knew whether each partner was unitary, "the Partnership is not going to prepare the K-1s differently for each partner."

It is understood that where there are a multitude of partners, the partnership may choose to not analyze unity for each individual partner before filing its schedule K-1s attached to its form 565.

For example, if there are 1,000 partners in Partnership X, and 250 of those partners are unitary with X, while 750 are not unitary with X, according to the commentator, Partnership X would file its schedule K-1 using the single-sales factor formula election for all partners even though it is only authorized to make the election for the 750 nonunitary partners. The 750 nonunitary partners would then use the data from the schedule K-1 and include their distributive share items of California source income in their own returns under Regulation section 25137-1, subsection (g). The 250 unitary partners would disregard the schedule K-1 and either elect or not elect the single-sales factor formula for their own independent apportioning trade or business as indicated on Part B of schedule R-1 attached the partner's form 100. Regardless of whether the single-sales factor formula election is made by each unitary partner's apportioning trade or business, the unitary partner's distributive share of income and factors would be combined with those of the unitary partner under Regulation section 25137-1, subsection (f). If several years later there is an FTB audit and 100 of the unitary partners are determined to be not unitary with Partnership X and are decombined, then those decombined partners would later be allowed to amend their California forms 100 to reflect their California source income

using the single-sales factor formula on Part B of schedule R-1 as was originally indicated on the schedule K-1s filed by Partnership X, so long as the single-sales factor formula was used to determine the distributive share items of income for all nonunitary partners. The schedule K-1s would already have been filed using the single-sales factor formula and no amendment would be needed on that set of facts.

The example identifies the forms that must be amended if a single-sales factor formula election is going to be made after forced de-combination of a partner from a partnership at audit, "Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565." In the above example, if the Partnership used the single-sales factor formula on all of its California schedule K-1s, with a notation that California source amounts in column (e) should be disregarded for unitary partners, then no later amendment by the partnership would be required.

If, on the other hand, the facts are that Partnership X does not elect to use the single-sales factor formula to determine the California source income of its nonunitary partners on its schedule K-1, and later 100 of the 250 "unitary" partners are de-combined at audit and would like to use the single-sales factor formula to determine their California source income, the Partnership X would need to file an amended form 565 with the single-sales factor formula indicated on Part B of schedule R-1, and the same election would need to be made for all nonunitary partners. Since there were 750 nonunitary partners for which the partnership did not elect originally, it would not be possible to have the decombined 100 partners use the single-sales factor formula to determine their California Source income.

These are all different fact situations that are already covered by the language provided, hence no change is warranted.

3. Subsection (b)(6) at Example 3, page 10, states that certain disregarded entities make a single-sales factor election by attaching schedule R-1 to form 568. The 568 Instruction Booklet should be updated to include the requirement for certain disregarded entities to attach schedule R-1 since that is currently not a required attachment pursuant to the existing instructions (see Filing Requirements for Disregarded Entities at page 11 of the 2010 Instruction Booklet).

Response:

No changes were made to subsection (b)(6) in the 15-day Notice issued on June 8, 2011. Any updates to instruction booklets will be addressed outside of this regulation process and hence no change in the regulation is warranted.

4. Subsection (b)(7)(B), at page 11 - suggest deleting "nonunitary" for form 565 and form 568 since the partnership and/or limited liability company will not know which partners or members are unitary (the timely election made by the partnership and/or limited liability company will only be applicable to those partners or members who are not unitary anyway).

Response:

This comment is consistent with the commentator's earlier comments regarding the filing of the form 565. As explained above, staff believes the rules as set forth are clear. The partnership may only elect to use the single-sales factor formula for nonunitary partners because the partnership is only a separate apportioning trade or business to that extent. The statutes (Revenue and Taxation Code

sections 25128 and 25128.5) require the apportioning trade or business to utilize one apportionment scheme, either the single-sales factor formula or the four-factor double-weighted sales factor formula. Therefore it is necessary to determine the scope of the apportioning trade or business. With regard to a partnership, to the extent the partnership is unitary with a partner, it is not a separate trade or business but rather is a part of the larger trade or business conducted by the partner and therefore the distributive share of income and factors must be determined using the election made by the partner for its apportioning trade or business because the partnership is part of that partner's apportioning trade or business rather than a separate trade or business. If the partnership is not unitary with its partners, then it may be an apportioning trade or business on its own and make its own election. Therefore, the subsection (b)(7)(B) is correct as written and no change is warranted.

5. Subsection (c)(1) says that for those corporations that elect single-sales factor formula apportionment they must use the single-sales factor formula for distributive share items of income and factors from unitary partnerships. Since the distributive share of income will be determined by the corporate partner's profit or loss sharing percentage, it is confusing to include income in this reference. Since the distributive share of factors will also be determined by the corporate partner's profit, loss, or capitals interest, it is also confusing to say that the single-sales factor must be used in determining factors from unitary partnerships. Suffice it to say that "Corporations that elect single-sales factor formula apportionment must include only the distributive shares of sales from unitary partnerships." The subsequent examples may need this confusing language cleaned up as well.

Response:

The modifications noticed on June 8, 2011 included only a change to the ownership ratios in Example 3. Subsection (c)(1) was not itself changed.

Subsection (c)(1) states that where a corporation elects single-sales factor formula apportionment, the corporation must also use the single-sales factor formula for any unitary partnerships in which it is a partner. In other words, a corporate partner may not elect to use the single-sales factor formula for all of its apportioning trade or business except for determining its California source income and factors from a unitary partnership, and instead use three-factor formula apportionment for the determination of income and factors coming from the partnership. Accordingly, no modification of the language is warranted.

6. Subsection (c)(1) at Example 1, page 12 - suggest deleting "Partnership Y is unitary with Group A but not with Group B" and replacing with "Corporation A determines it is unitary with Partnership Y and Corporation B determines it is not unitary with Partnership Y". Then, suggest deleting the last three words "for Corporation B" and including the following sentence "Such election by Partnership Y will be controlling for nonunitary partner Corporation B."

Response:

The modifications noticed on June 8, 2011 included only a change to the ownership ratios in Example 3, with no change made to Example 1.

The suggested change from "Partnership Y is unitary with Group A but not with Group B" to "Corporation A determines it is unitary with Partnership Y and Corporation B determines it is not unitary with Partnership Y" is simply a change in reference point and is not necessary to provide guidance. What is important in the example is to determine which entities are unitary and which are not. The example makes that identification. Accordingly, no modification is warranted.

7. Subsection (c)(1) at Example 2, page 13 - suggest deleting "M is unitary with Corporation C, but not with Corporations A or B" and replacing with "Corporation C has determined it is unitary with M and Corporations A and B have determined neither is unitary with M". Then, suggest deleting "M may make a single-sales factor method election to determine the California source income for Corporations A or B" and replacing with "If M makes a single-sales factor method election to determine the California source income of its members, such election will be controlling as to nonunitary members Corporations A and B but will be non-controlling as to unitary member Corporation C".

Response:

The modifications noticed on June 8, 2011 included only a change to the ownership ratios in Example 3, with no change made to Example 2. The suggested change from "M is unitary with Corporation C, but not with Corporations A or B" to "Corporation C has determined it is unitary with M and Corporations A and B have determined neither is unitary with M" is simply a change in reference point and is not necessary to provide guidance. What is important in the example is to determine which entities are unitary and which are not. The example makes that identification. Accordingly, no modification is warranted.

8. Subsection (c)(1) at Example 3, page 13 misconstrues the unity of ownership and combined reporting rules. Suggest replacing in its entirety with the following:

> Example 3: Partnership X operates an apportioning trade or business and is owned 40 percent by a limited liability company (R) treated as a partnership and 60 percent by a limited liability company (T) that has elected to be treated as a corporation. T is owned more than 50 percent by Corporation B. R operates its own apportioning trade or business and is owned 5 percent by Corporation A, 85 percent by Corporation B, and 10 percent by a limited liability company (S) treated as a partnership and conducting no independent activity other than holding an interest in R. Corporations B and T are a combined reporting group where Corporation T has determined it is unitary with X and Corporation B has determined it is unitary with both R and X. The unitary trade or business activity of combined reporting group B and T, including the distributive shares from X and R, is Group Y. Corporation A has determined it is unitary with R but not with X. S is owned by individual members, none of which have determined they are unitary with S. If X makes a single-sales factor method election to determine the California source income of its partners, such election will not be controlling as to B and T, but will be controlling as to A and the individual members of S. If R makes a single-sales factor method election to determine the California source income of its members, such election will not be controlling as to B and A, but will be controlling as to the individual members of S. If Group Y wants to make a single-sales factor method election, both Corporations B and T must elect or the election must be made on the Group Y combined report. With such election, Corporation B would add to its own income and factors, its 85 percent distributive share of income and sales from R (which would include R's 40 percent distributive share of income and sales from X) and Corporation T would add to its own income and factors its 60 percent distributive share of income and sales from X. If A makes a single-sales factor method election, it would add to its own income and factors its 5 percent distributive share of income and sales from R (which would not include R's 40 percent distributive share from X since A is not unitary with X). A would include its 5 percent distributive share of R's 40 percent distributive share of any California source income from nonunitary X.

Response:

The modifications noticed on June 8, 2011 included only a change to the ownership ratios in Example 3, as recommended by this commentator who now requests further changes to this example. The commentator significantly changes the facts of the example without explaining why the changes are necessary to provide guidance. In addition, the commentator does not explain how Example 3 misconstrues the unity of ownership and combined reporting rules.

In the original example, because R and T are unitary with Partnership X, the distributive shares of income and factors from X would flow through to R and T. This is addressed in the example. Since R and T are unitary with X, under Regulation section 25137-1, subsection (f), the distributive share items of income and factors from the partnership would be combined with those of the unitary owner. After this, apportionment for R, an LLC treated as a partnership, is addressed because a partnership files only an information return and the tax liability flows through to the partners. This is also addressed in the example. How the apportionment takes place for the partners of R is determined by whether the partners are unitary or not unitary with R. This is explained in the example.

The commentator would change the example to have T owned more than 50 percent by Corporation B (which also owns 85 percent of R as per the original example facts). In addition, the commentator would identify B and T as a combined reporting group, and then would have T determine that it is unitary with Partnership X, and B determine that it is unitary with the LLC treated as a partnership R and Partnership X. The commentator would designate a combined reporting group as containing certain corporations or LLCs treated as corporations, and then indicate that the partnerships are unitary with these combined reporting group members. This is an alternate method of explaining the facts for an example. Nothing in the original example as provided is incorrect, however. The example as originally provided does not identify corporations that are in the combined reporting group and then also identify the unitary partnerships. The example simply discusses which entities are unitary with each other, since that is the pivotal fact. The example as originally provided also states which entities are unitary, rather than determining where the decision is made as to unity. While realistically it might be the case that corporate owners are the ones that determine whether they are unitary with a partnership, that fact is not critical to understanding how the apportionment is performed for unitary and nonunitary corporate partners. Accordingly, no modification is warranted.

9. Subsection (c)(2)(B), at page 14 - suggest deleting "A nonresident individual who is a partner in" and then replacing "but if the partnership does elect to use the single factor formula, the partnership must use the single-sales factor formula" with "which election is controlling."

Response:

The modifications noticed on June 8, 2011 included only the addition of the word "nonunitary" as recommended by this commentator who is now requesting further changes unrelated to the addition of the word "nonunitary."

The subsection (c)(2)(B) as currently drafted states,

> (B) Partnerships to the extent owned by individuals. A nonresident individual who is a partner in a partnership that engages in activities partly within and partly without the state may determine California source income, as provided in California Code of Regulations section 17951-4, subsection (d)(1), using the single-sales factor formula on Part B of schedule R-1 of form 565, but if the partnership does elect to use the single factor formula, the partnership must use the single-

sales factor formula to determine California source income for all nonunitary nonresident partners.

Making the requested substitutions, subsection (c)(2)(B) would read as follows,

(B) Partnerships to the extent owned by individuals. A partnership that engages in activities partly within and partly without the state may determine California source income, as provided in California Code of Regulations section 17951-4, subsection (d)(1), using the single-sales factor formula on Part B of schedule R-1 of form 565, which election is controlling to determine California source income for all nonunitary nonresident partners.

The requested changes, again provided without explanation, are another way of phrasing the same information. Nothing in the original version as drafted is incorrect and there are many different ways to phrase this guidance. The commentator has omitted the reference to the non-resident individual who is the partner, preferring to refer at the outset only to the partnership, even though it is the partner that has the tax liability. The example specifically addresses partnerships that are owned by non-resident individuals so it is reasonable and instructive to begin the subsection with a reference to the individual non-resident partner. Deleting that reference does not enhance clarity. The commentator also deletes the language that explains that the partnership must make the election for all non-resident partners, instead preferring to say that the "election is controlling to determine California source income for all nonunitary non-resident partners." This alternative suggested version is correct in what it states, but does not enhance clarity over the current version as drafted, it is simply shorter. Accordingly, no modification is warranted.

pillsbury

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March 25,2011

BY ELECTRONIC MAIL

Colleen Berwick, Regulations Coordinator
Franchise Tax Board, Legal Department
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Re: Proposed Regulation 25128.5

Dear Ms. Berwick:

This letter is submitted on behalf of Pillsbury Winthrop Shaw Pittman LLP in connection with proposed Section 25128.5 of title 18 of the California Code of Regulations ("Proposed Regulation") concerning the single-sales factor formula election. Our comments address inconsistencies in the Proposed Regulation and an error in the Initial Statement of Reasons, each concerning the ability of a taxpayer to make a single.:.sales factor election for a separate apportioning trade or business conducted through a nonunitary partnership in which the taxpayer owns an interest.

1. Proposed Regulation 25128.5(b)(6) and 25128.5(c)(2)

California Revenue and Taxation Code ("CRTC")section 25128.5 authorizes "any apportioning trade or business" other than those described in CRTC section 25128(b) to annually elect to apportion by use of a single-sales factor all business income of such apportioning trade or business. It is well-established that a taxpayer may have more than one trade or business.[1] In such cases, it is necessary to detennine the business income attributable to each separate trade or business which is then apportioned by formula.[2] When the activities of a partnership and a taxpayer do not

[1] Regulation 25120(b).

[2] Id.

constitute a unitary business, the taxpayer's share of the partnership's trade or business shall be treated as a separate trade or business *of the taxpayer.*[3]

Proposed Regulation 25128.5(b)(6) provides:

> A taxpayer that is engaged in more than one apportioning trade or business as defined in Revenue and Taxation Code section 25128, subdivision (d)(6), may mak.e a separate election for each apportioning trade ofbusiness.

This section of the Proposed Regulation acknowledges that a taxpayer may have more than one trade or business, and therefore may make separate single-sales factor elections for each of those businesses. Since a nonunitary partnership is treated as a separate trade or business of a taxpayer/corporate partner, such taxpayer should be permitted to elect the single-sales factor method to apportion the income from such a separate trade or business conducted in partnership form.

Proposed Regulation 25128.5(c)(2) addresses the single-sales factor election for a trade or business conducted in partnerships form, and states as follows:

> Partnerships. Corporations that elect single-sales factor formula apportionment must use the single-sales factor formula for distributive share items of income from unitary partnerships.
>
> Example 1. Corporation A is a taxpayer. Corporation A and B are members of a combined reporting group. Corporation A owns 50 percent of the unitary Partnership Y. Accordingly, 50 percent of Partnership Y's income and factors are included in Corporation A and Corporation B's combined report. Corporation A makes a single-sales factor formula election. Corporation A's sales factor will include the California sales ofPartnership Y to the extent of its ownership interest. Partnership Y's payroll and property will be disregarded for apportionment purposes consistent with Corporation A's election.
>
> Example 2. Same facts as Example 1 except that Corporation A owns 50 percent ofthe nonunitary Partnership Z instead of a 50 percent interest in unitary Partnership Y. Pursuant to California Code of

[3] Regulation 25137-l(a) and (g).

> Regulations section 25137-1, subsection (g), Corporation A's distributive share of Partnership Z's income is treated as income from a separate trade or business and Corporation A's single sales factor election does not apply to determining Partnership Z's California sourced income. Partnership Z's California source income is separately determined utilizing the rules contained in California Code of Regulations, section 25137-1, subsection (g).

Proposed Regulation 25128.5(c)(2), however, fails to address the ability of a corporation to elect the single-sales factor method of apportioning income from its nonunitary partnership interests. Example 2 correctly concludes that an election made by a corporate partner does not apply to its nonunitary partnership, but fails to specifically state that a corporation may make a separate single-sales factor election to apportion the income from its trade or business conducted in partnership form. Thus, consistent with Proposed Regulation 25128.5(b)(6), we suggest amending Proposed Regulation 25128.5(c)(2) to reflect this ability, as follows:

> Partnerships. Corporations that elect single-sales factor formula apportionment must use the single-sales factor formula for distributive share items of income from unitary partnerships. Corporate partners may elect single-sales factor formula apportionment for distributive share items of income from nonunitary partnerships.
>
> Example 1. Corporation A is a taxpayer. Corporation A and Bare members of a combined reporting group. Corporation A owns 50 percent of the unitary Partnership Y. Accordingly, 50 percent of Partnership Y's income and factors are included in CorporationA and Corporation B's combined report. Corporation A makes a single-sales factor formula election. Corporation A's sales factor will include the California sales ofPartnership Y to the extent of its ownership interest. Partnership Y's payroll and property will be disregarded for apportionment purposes consistent with Corporation A's election.
>
> Example 2. Same facts as Example 1 except that Corporation A owns 50 percent of the nonunitary Partnership Z instead of a 50 percent interest in unitary Partnership Y. Pursuant to California Code of Regulations section 25137-1, subsection (g), Corporation A's distributive share of Partnership Z's income is treated as income from a separate trade or business of Corporation A, and Corporation A's single sales factor election does not apply to its distributive share of

determining Partnership Z's California sourced income. Partnership Z's California source income is separately determined utilizing the rules contained in California Code of Regulations, section 25137 1, subsection (g). Corporation A may make a separate single-sales factor election to apportion its distributive share of income from Partnership Z as a separate trade or business pursuant to California Code of Regulations section 25128.5 subsection (b)(6).

2. Initial Statement of Reasons

The Initial Statement of Reasons erroneously states that if a corporate partner is not unitary with the partnership, a single-sales factor election cannot be made because "the partnership is a separate trade or business and not a combined reporting group member."[4]

As noted above, when the activities of a partnership and a taxpayer do 'not constitute a unitary business, the taxpayer's share of the partnership's trade or business shall be treated as a separate trade or business *of the taxpayer*. Further, CRTC section 25128.5 explicitly authorizes single-sales factor elections for "any apportioning trade or business," and Proposed Regulation 25128.5(b)(6) recognizes the ability of a taxpayer with separate businesses to make separate elections. Thus, the fact that a nonunitary partnership is treated as a separate trade or business of the taxpayer is precisely what enables the taxpayer to make a separate election for that separate trade or business.

The fact that a partnership is not a combined reporting group member is irrelevant, as the corporate partner, not the partnership, would make the election for its separate apportioning trade or business conducted in partnership form. Furthermore, membership in a combined reporting group is not required to make a single-sales factor election, which is available to "any apportioning trade or business." Thus, the Initial Statement of Reasons should be revised accordingly.

3. Definition of "Apportioning trade or business"

Finally, the definition of "apportioning trade or business" in Proposed Regulation 25128.5(a)(2) conflicts with CRTC section 25128(d)(6), and is internally inconsistent with Proposed Regulation 25128.5(b)(6).

[4] Initial Statement of Reasons, pg. 11.

Proposed Regulation 25128.5(b)(6) defines "apportioning trade or business" by reference to the definition provided by CRTC section 25128(d)(6), which defines "apportioning trade or business" as follows:

> A distinct trade or business whose business income is required to be apportioned under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors.

Proposed Regulation 25128.5(a)(2) defines "apportioning trade or business" as follows:

> A distinct trade or business whose business income is required to be apportioned under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors. *An apportioning trade or business includes at least one taxpayer member.*

(Emphasis added.)

The additional requirement that *[a}n apportioning trade or business includes at least one taxpayer member* is inconsistent with the definition of "apportioning trade or business" under CRTC section 25128(d)(6), incorporated by reference in Proposed Regulation 25128.5(b)(6), by suggesting that an apportioning trade or business cannot be conducted by a single taxpayer. To eliminate this inconsistency and promote clarity, the last sentence of Proposed Regulation 25128.5(a)(2) should be removed.

In sum, the Proposed Regulation should state explicitly that a corporate partner is permitted to elect single-sales factor formula apportionment for its distributive share items of income from nonunitary partnerships, and provide a consistent definition of an "apportioning trade or business." Finally, the Initial Statement of Reasons should be modified to reflect the foregoing.

truly yours,

Je ey M. Vesely

cc: Keme H. 0. Matsubara
Annie H. Huang
Michael J. Cataldo

From: Joyce Dillard [mailto:dillardjoyce@yahoo.com]
Sent: Tuesday, March 29, 2011 4:46 PM
To: Berwick.Colleen
Subject: Comments to FTB Single Sales Factor Formula Election due 3.29.2011

Comments to FTB Single Sales Factor Formula Election due 3.29.2011

How are non-profit corporations treated in this calculation if they are a partner in a Limited Liabilty Corporation or Limited Liability Partnership.

How are CDFI Community Development Financial Institutions treated.

Joyce Dillard
P.O. Box 31377
Los Angeles, CA 90031

Comments on Proposed Amendments
§ 25128.5 Single Sales Factor Formula Election

Errata

Subsection (b)(4)(C), at the Example on pages 7/8, suggested changes **highlighted**:

- Line 8 should read - taxpayers begins on July 1, 2011 and ends on **December 31, 2011**. The business

- Line 18 should read - test will be based on a comparison of the business assets for the **first** six-month

Subsection (b)(5)(A), at page 8, suggest deleting (A) since a stand-alone provision.

Subsection (b)(5)(A), at Example 4 on page 9, suggested changes **highlighted**:

- Line 15 should read - September **13** (60 days from the date of audit determination) of Year 6 to

- Line 22 should read - Of October 15, **Year 6** and may use the single-sales factor formula to determine

Clarification

Subsection (b)(3), at page 5, suggested example:

Example 4: Same facts as Example 1, except that general corporations B and C are unitary partners in Partnership F that conducts a banking or financial business activity. Group X now receives more than 50 percent of its gross business receipts from the activities of Corporation A and the distributive shares from Partnership F. Group X may not make the single-sales factor formula election.

Subsection (b)(5)(A), at Example 1 on page 8, suggested modification **highlighted**:

- Line 6 - election for **any of the** Years 1 through 6 by August 15 of Year 7. Thereafter,

Subsection (b)(5)(A), at Example 4 on page 9, suggest modifying completely to say:

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Partnership X determines the California source income for both of its partners using the single-sales factor formula as properly indicated on Part B of schedule R-1 of forms 565 for Years 1 through 4 (Partnership X is unaware of whether any of its partners are unitary). Corporation B determines that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4. Corporation A determines that its apportioning trade or business is not unitary with Partnership X. Corporation A makes no election for its separate apportioning trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2,

with a determination dated July 15 of Year 6. Because Corporation B is found not unitary with Partnership X and due to the original election made by Partnership X, the California source income as reflected on the K-1 to Corporation B is included as part of the audit adjustment proposed by the Franchise Tax Board and this subsection is not operative.

Subsection (b)(5)(A), at page 9, suggest inserting a follow-up example, as follows:

Example 5: Same facts as Example 4, except that Partnership X did not make a single-sales factor formula election on Part B of schedule R-1 of forms 565 for Years 1 through 4. Corporation B and Partnership X may file amended returns for Years 1 through 4 by no later than September 13 (60 days from the date of audit determination) of Year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula and Partnership X's factors. Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15, Year 6 and may use the single-sales factor formula to determine the California source income of its partners on a timely filed original Part B of schedule R-1 of form 565 for that year.

Subsection (c)(1), at Example 3 on page 13, suggest having limited liability company (T) owned greater than 50 percent by Corporation B, or a common owner of both Corporation B and limited liability company (T) so that it is clear that Group Y meets the unity of ownership requirement. Determine if the example needs to modify the discussion of the single-sales factor formula election made by Corporation B.

Subsection (c)(2)(B), at page 15, suggest the following **modification** and additional examples:

- Line 7, suggest inserting nonunitary to read - determine California source income for all **nonunitary** nonresident partners.

- Change existing Example to Example **1**

- Add the following examples.

Example 2: Professional Partnership Y is comprised of 1,000 partners, 200 of which are resident individuals and 800 of which are nonresident individuals. If Partnership Y makes the single-sales factor formula election on the original Part B of schedule R-1 of form 565, all of the nonresident individual partners' California source income is determined using the election and while all of the resident individual partners are taxed on income from all sources, for state tax credit purposes the single-sales factor election must be used.

Example 3: Limited Partnership MF is comprised of two nonresident individual general partners that are unitary (as provided in California Code of Regulations section 17951-4(d)(5)(A)) with MF and other business activities of these two individuals, and 1,000 limited partners that are nonunitary individuals and may or may not all be nonresidents of California. A single-sales factor formula election on the original Part B of schedule R-1 of form 565 is not binding on the two unitary nonresident individual general partners but is binding on all of the limited partners. For those nonresident individual limited partners, the election made by MF determines the California source income to be reported by them. While the resident individual limited partners are taxed on income from all sources, for state tax credit purposes the election made by MF must be used.

Comments on 2nd Set of Proposed Amendments
California Code of Regulations § 25128.5
June 20, 2011

Clarification

- Subsection (b)(3), at page 5, - suggest flipping Examples 3 and 4.

Subsection (b)(5) at Example 4, page 9, states that Partnership X makes the single-sales factor election for Corporation A only and that, after FTB audit, Corporation B and Partnership X can file amended returns so that Partnership X can make a single-sales factor election for Corporation B. First, it would be unusual for the Partnership to know which corporate partners are unitary and which are not. Second, even if the Partnership was told by one or both corporate partners that they were unitary with the Partnership, the Partnership is not going to prepare the K-1s differently for each partner. If the Partnership is eligible to make, and does make, a single-sales factor election and determines the California source amounts to report in column (e) of Schedule K-1, it will likely attach a statement (for Schedule K-1, line 20c) saying that for those partners who have determined they are unitary with the Partnership the California source amounts determined and reported in column (e) of Schedule K-1 should be ignored and the unitary partner should pick up its share of the distributive income and factors at Table 2 and include those amounts in determining the partner's California source income from its unitary trade or business that includes the distributive share from the Partnership.

Subsection (b)(6) at Example 3, page 10, states that certain disregarded entities make a single-sales factor election by attaching schedule R-1 to form 568. The 568 Instruction Booklet should be updated to include the requirement for certain disregarded entities to attach schedule R-1 since that is currently not a required attachment pursuant to the existing instructions (see Filing Requirements for Disregarded Entities at page 11 of the 2010 Instruction Booklet).

- Subsection (b)(7)(B), at page 11 - suggest deleting "nonunitary" for form 565 and form 568 since the partnership and/or limited liability company will not know which partners or members are unitary (the timely election made by the partnership and/or limited liability company will only be applicable to those partners or members who are not unitary anyway).

Subsection (c)(1) says that for those corporations that elect single-sales factor formula apportionment they must use the single-sales factor formula for distributive share items of income and factors from unitary partnerships. Since the distributive share of income will be determined by the corporate partner's profit or loss sharing percentage, it is confusing to include income in this reference. Since the distributive share of factors will also be determined by the corporate partner's profit, loss, or capitals interest, it is also confusing to say that the single-sales factor must be used in determining factors from unitary partnerships. Suffice it to say that "Corporations that elect single-sales factor formula apportionment must include only the distributive shares of sales from unitary partnerships." The subsequent examples may need this confusing language cleaned up as well.

- Subsection (c)(1) at Example 1, page 12 - suggest deleting "Partnership Y is unitary with Group A but not with Group B" and replacing with "Corporation A determines it is unitary with Partnership Y and Corporation B determines it is not unitary with Partnership Y". Then, suggest deleting the last three words "for Corporation B" and including the following sentence "Such election by Partnership Y will be controlling for nonunitary partner Corporation B."

- Subsection (c)(1) at Example 2, page 13 - suggest deleting "M is unitary with Corporation C, but not with Corporations A or B" and replacing with "Corporation C has determined it is unitary with M and Corporations A and B have determined neither is unitary with M". Then, suggest deleting "M may make a single-sales factor method election to determine the California source income for Corporations A or B" and replacing with "If M makes a single-sales factor method election to determine the California source income of its members, such election will be controlling as to nonunitary members Corporations A and B but will be non-controlling as to unitary member Corporation C".

Subsection (c)(1) at Example 3, page 13 misconstrues the unity of ownership and combined reporting rules. Suggest replacing in its entirety with the following:

- Example 3: Partnership X operates an apportioning trade or business and is owned 40 percent by a limited liability company (R) treated as a partnership and 60 percent by a limited liability company (T) that has elected to be treated as a corporation. T is owned more than 50 percent by Corporation B. R operates its own apportioning trade or business and is owned 5 percent by Corporation A, 85 percent by Corporation B, and 10 percent by a limited liability company (S) treated as a partnership and conducting no independent activity other than holding an interest in R. Corporations B and T are a combined reporting group where Corporation T has determined it is unitary with X and Corporation B has determined it is unitary with both R and X. The unitary trade or business activity of combined reporting group B and T, including the distributive shares from X and R, is Group Y. Corporation A has determined it is unitary with R but not with X. S is owned by individual members, none of which have determined they are unitary with S. If X makes a single-sales factor method election to determine the California source income of its partners, such election will not be controlling as to B and T, but will be controlling as to A and the individual members of S. If R makes a single-sales factor method election to determine the California source income of its members, such election will not be controlling as to B and A, but will be controlling as to the individual members of S. If Group Y wants to make a single-sales factor method election, both Corporations B and T must elect or the election must be made on the Group Y combined report. With such election, Corporation B would add to its own income and factors, its 85 percent distributive share of income and sales from R (which would include R's 40 percent distributive share of income and sales from X) and Corporation T would add to its own income and factors its 60 percent distributive share of income and sales from X. If A makes a single-sales factor method election, it would add to its own income and factors its 5 percent distributive share of income and sales from R (which would not include R's 40 percent distributive share from X since A is not unitary with X). A would include its 5 percent distributive share of R's 40 percent distributive share of any California source income from nonunitary X.

- Subsection (c)(2)(B), at page 14 - suggest deleting "A nonresident individual who is a partner in" and then replacing "but if the partnership does elect to use the single factor formula, the partnership must use the single-sales factor formula" with "which election is controlling".

§ 25128.5. Single-Sales Factor Formula Election.

(a) Definitions. For purposes of this regulation, the following definitions are applicable:

(1) Affiliated corporations. "Affiliated corporations" are corporations related by common ownership.

(2) Apportioning trade or business. "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned because it has income derived from sources within this state and from sources outside this state. An apportioning trade or business can be conducted in many forms, including, but not limited to, the following:

(A) A corporation.

(B) A corporation that is a member of a combined reporting group.

(C) A division of a corporation engaged in a separate trade or business not unitary with the other trades or businesses of the corporation.

(D) A partnership to the extent owned by a corporate partner that is not unitary with the partnership, whether the corporation stands alone or is a member of a combined reporting group.

(E) A partnership to the extent owned by a partner who is an individual who is not a resident of California.

(F) A sole proprietorship that is operated by an individual who is not a resident of California.

(3) Apportionment. "Apportionment" is the means by which the total business income of an apportioning trade or business is assigned to this state under Revenue and Taxation Code sections 25128 through 25137 and section 25141.

(4) Banking or financial business activity. “Banking or financial business activity” means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

(5) Business assets. "Business assets" are assets, including intangible assets, other than stock of a member of the combined reporting group, which are used in the conduct of the business of the combined reporting group or would produce business income to the combined reporting group if the assets were sold.

Business assets are valued at net book value as of the date that electing taxpayers and non-electing taxpayers or non-taxpayers become members of a new combined reporting group. A copy of the taxpayer's valuation of the business assets must be made available when required by the Franchise Tax Board. The Franchise Tax Board may, in its sole discretion, allow an alternative valuation date if it determines that an alternative date would be more appropriate.

(6) Business asset test. The "business asset test" is the mechanism of comparing business assets to determine if members of a combined reporting group are required to use the standard formula under Revenue and Taxation Code section 25128 or the single-sales factor formula under Revenue and Taxation Code section 25128.5 and this regulation.

(7) Combined reporting group. A "combined reporting group" is as defined by California Code of Regulations section 25106.5, subsection (b)(3).

(8) Commencement date. The "commencement date" of a single-sales factor formula election is the first day of the period for which the election is made.

(9) Common Ownership. "Common ownership" exists if:

(A) A parent corporation owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,

(B) Stock cumulatively representing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph (A), or one or more other corporations that satisfy the conditions of this subparagraph.

(10) Corporation. References to “corporation” include a Subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation pursuant to Revenue and Taxation Code sections 23038 or 23038.5.

(11) Disregarded Entity. A "disregarded entity" is an entity described in California Code of Regulations section 23038(b)-2, subsection (a).

(12) Good cause. "Good cause" shall have the same meaning as specified in Treasury Regulation section 1.1502-75(c).

(13) Gross business receipts. "Gross business receipts" is as defined by Revenue and Taxation Code section 25128, subdivision (d)(1).

(14) Group Return. A "group return" is as defined by California Code of Regulations section 25106.5, subsection (b)(13).

(15) Limited liability company. A "limited liability company" is as defined at Revenue and Taxation Code section 17941, subdivision (d).

(16) Member. "Member" is as defined by California Code of Regulations section 25106.5, subsection (b)(10).

(17) Net book value. "Net book value" is equal to an asset's original cost minus depreciation, depletion and amortization. Book value means the amount which an

asset is carried on a balance sheet. Depreciation means the systematic write off of the cost of a tangible asset over the asset's useful life. Depletion means the systematic write off of the cost of harvesting or mining a natural resource. Amortization means the systematic write off of the cost of an intangible asset over the asset's useful life. Book value, depreciation, depletion and amortization will be reflected using United States Generally Accepted Accounting Principles (US GAAP). If any member of a combined reporting group does not maintain its books using US GAAP, the Franchise Tax Board may allow an alternative method of valuation of that member's business assets.

(18) New combined reporting group. A "new combined reporting group" is a combined reporting group that is created by a new affiliation of two or more corporations, or by the addition of one or more new members to an existing combined reporting group.

(19) Nonresident. A "nonresident" is as defined in California Code of Regulations section 17014.

(20) Original return. The "original return" is the last return filed on or before the due date (taking extensions into account) regardless of the form on which it is filed or however it may be denominated. A return filed after the due date (taking extensions into account) regardless of the form on which it is filed or however it may be denominated may be an original return, if no other return has been filed, but it would not be a timely filed, original return.

(21) Partnership. A "partnership" is as defined in Revenue and Taxation Code section 17008 and includes entities treated as partnerships as set forth in California Code of Regulations section 23038(b)-3.

(22) Qualified business activities. "Qualified business activities" are as defined in Revenue and Taxation Code section 25128, subdivision (c).

(23) Qualified Subchapter S subsidiary: A "qualified Subchapter S subsidiary" is as defined in Internal Revenue Code section 1361, subsection (b)(3), as incorporated by Revenue and Taxation Code section 23800 and as modified by Revenue and Taxation Code section 23800.5.

(24) Resident. A "resident" is as defined in Revenue and Taxation Code section 17014, subdivision (a), and California Code of Regulations section 17014, subsection (a).

(25) S corporation. An "S corporation" is as defined in Internal Revenue Code sections 1361 and 1362, as modified by Revenue and Taxation Code sections 23800.5 and 23801.

(26) Sole Proprietorship. A "sole proprietorship" is an unincorporated trade or business that is operated by one individual.

(27) Standard formula. The "standard formula" is the three-factor method of apportionment as defined by Revenue and Taxation Code section 25128 and California Code of Regulations section 25128.

(28) Taxpayer. "Taxpayer" means an individual, corporation, or partnership with a requirement to file a California franchise or income tax return.

(29) Taxpayer member. "Taxpayer member" is as defined by California Code of Regulations section 25106.5, subsection (b)(11).

(30) Timely filed. A "timely filed" return is one filed on or before the due date (taking extensions into account).

(31) Unitary. One corporation or partnership is "unitary" with another corporation or partnership if they are engaged in a unitary business.

(32) Unitary business. A “unitary business” consists of those activities required to be included in a combined report pursuant to Revenue and Taxation Code section 25101 and the published cases decided thereunder by the United States Supreme Court, the courts of this State, and the California State Board of Equalization. Activities constitute a "unitary business" if unity of ownership, unity of operation, and unity of use are present, or if the activities carried on within the state contribute to or are dependent upon the activities carried on without the state. California Code of Regulations section 25120, subsection (b), sets forth certain indicia and standards for determining whether activities constitute a single trade or business and are therefore unitary.

(b) Electing the Single-Sales Factor Formula.

(1) To make a single-sales factor formula election permitted by Revenue and Taxation Code section 25128.5, a taxpayer must make an election on a timely filed, original return for the year of the election. For an election to be effective for purposes of apportioning the business income of a combined reporting group, each taxpayer member of the combined reporting group that is subject to taxation under Part 11 of the Revenue and Taxation Code must make the election.

Example: Corporation P, a calendar year California taxpayer, has a subsidiary, Corporation A, which is also a calendar year California taxpayer. Corporation P and Corporation A are members of the same combined reporting group. On its separate timely filed return, Corporation P makes a single-sales factor formula election. Conversely, on its separate timely filed return, Corporation A does not make a single-sales factor formula election. As a result, neither Corporation P nor Corporation A are deemed to have made a single-sales factor formula election.

(2) An election made on a group return is an election by each taxpayer member included in that group return. However, the election made on the group return will not have any effect if a taxpayer member of the combined reporting group files a separate return in which no election is made, unless subsection (b)(4)(C) applies.

(3) An apportioning trade or business that includes one or more qualified business activities may make the single-sales factor election provided the apportioning trade or business does not derive more than 50 percent of its gross business receipts from qualified business activities.

Example 1: Corporation A is a bank or financial corporation. Corporations B and C are general corporations. Corporation A, B, and C are members of the same combined reporting group, Group X. Group X receives less than 50 percent of its gross business receipts from qualified banking and financial activities. Accordingly, Corporation A may make the single-sales factor formula election along with Group X.

Example 2: Same facts as Example 1, except that Group X receives more than 50 percent of its gross business receipts from qualified banking and financial activities. Corporation A must apportion pursuant to Revenue and Taxation Code section 25128, subdivision (b), and is precluded from making a single-sales factor formula election. Group X may not make the single-sales factor formula election.

Example 3: Partnership P conducts an apportioning trade or business and is owned 65 percent by Corporation W and 35 percent by Corporation T. Partnership P derives less than 50 percent of its gross business receipts from an extractive business activity. Partnership P, Corporation T, and Corporation W are not unitary with each other. As a result, Corporation W and Corporation T may not independently decide whether to make a single-sales factor method election for their distributive share items of income from the nonunitary Partnership P. However, Partnership P may use the single-sales factor formula to determine California source income for Corporation W and Corporation T on Part B of schedule R-1 of form 565 using the Partnership P factor(s) because Partnership P's separate apportioning trade or business derives less than 50 percent of its gross business receipts from qualified business activities.

Example 4: Same facts as Example 1, except that general corporations B and C are unitary partners in Partnership F that conducts banking and financial activity as a part of the combined reporting group, Group X. The distributive share of gross business receipts from Partnership F combined with the business receipts from Corporation A cause Group X to have more than 50 percent of its gross business receipts from qualified business activities. Group X may not make the single-sales factor formula election.

(4) Deemed Single-Sales Factor Formula or Standard Formula Elections and Non-Elections.

(A) Corporations that are non-electing taxpayers that are subsequently found to be members of a combined reporting group as the result of a Franchise Tax Board audit determination (represented by a notice of additional tax proposed to be assessed, a notice of proposed overpayment, notice of action on a claim for refund, or a letter from the tax auditor regarding a computational effect which does not result in a current year adjustment [e.g., a computation of net operating loss carryover]) shall be deemed to have elected the single-sales factor formula if the value of the total business assets of the electing taxpayer(s) is greater than those of the non-electing taxpayer(s). The commencement date of the deemed

single-sales factor formula election shall be the same as the commencement date of the electing taxpayers. If the value of total business assets of the electing taxpayers does not exceed the value of total business assets of the non-electing taxpayers, the single-sales factor formula election of each electing taxpayer is terminated as of the date the non-electing taxpayers are, pursuant to the audit determination, properly included in the same combined reporting group as the electing taxpayers. Non-electing taxpayers may not be deemed to have made a single-sales factor formula election if the Franchise Tax Board audit determination is withdrawn or otherwise overturned. For purposes of applying this paragraph, the business assets of other members of the combined reporting group that are not taxpayers shall not be taken into account.

Example 1: Corporation P is not a California taxpayer. It has two subsidiaries, Corporation A and Corporation B, that are California taxpayers, and another subsidiary, Corporation C, that is not a California taxpayer. Corporations P, A, and C are members of the same combined reporting group. Corporation A makes a single-sales factor formula election on its timely filed return which reflects the apportionment factors and income of Corporations P and C. Corporation B files a separate tax return as a standard formula non-electing taxpayer. Upon Franchise Tax Board audit, Corporation B is determined to be a member of the combined reporting group that includes Corporations A, P, and C. In the year of Corporation A's single-sales factor formula election, Corporation A's business assets are $500 million and Corporation B's business assets are $250 million. Based on the business asset test, Corporation B is deemed to have elected the single-sales factor formula, because Corporation A's business assets are greater than Corporation B's business assets. Corporations P and C's business assets are not taken into account in performing the business assets test, since neither P nor C are California taxpayers.

Example 2: Corporations A, B, and C are taxpayer members of the same combined reporting group. The original timely-filed group return for 2011 that was filed on behalf of each of them includes a single-sales factor election. Corporation D, which is owned by Corporation A, was not considered to be a member of Corporation A, B, and C's combined reporting group for 2011. Corporation D filed its own 2011 California tax return, which did not include a single-sales factor election. During an audit conducted in 2014, the FTB determined that Corporation D was a member of Corporation A, B, and C's combined reporting group for 2011. During 2011, Corporation D's business assets were greater than Corporation A, B, and C's combined business assets. Consequently, the single-sales factor election that was initially made on behalf of Corporations A, B, and C for 2011 is disregarded. For purposes of determining any proposed assessments relating to 2011 for Corporations A, B, and C, the FTB will recalculate the combined reporting group's business income using the standard formula.

(B) If a taxpayer member of a combined reporting group files a separate return based on the standard formula, while other taxpayer members of the combined reporting group included in a group return file based on the single-sales factor

formula, the business asset test will determine which method must be used for all taxpayer members of the combined reporting group.

Example 1: Corporations A, B, C, and D are California taxpayer members of a combined reporting group. Corporations A, B, and C file a group return using the single-sales factor formula. Conversely, Corporation D files a separate return using the standard formula. Pursuant to the business asset test, because the business assets of the electing Corporations A, B, and C are greater than the business assets of the non-electing Corporation D, Corporation D is deemed to have elected the single-sales factor formula.

Example 2: Same facts as Example 1, except that the business assets of Corporation D are greater than the combined business assets of Corporations A, B, and C. There is no single-sales factor formula election for Corporations A, B and C.

(C) When taxpayer members of a combined reporting group file separate returns because their relative tax years end on different dates and some taxpayer members have elected the single-sales factor formula, while others have not, for purposes of conducting the business asset test, the business assets for the electing and non-electing taxpayers will be compared for each common six-month period that occurs after January 1, 2011. Thereafter, the business assets test will be applied to the same common six-month period. The Franchise Tax Board may, in its sole discretion, allow an alternative method if it determines an alternative method would be more appropriate.

Example: Corporations A, B, C, and D are California taxpayer members of a combined reporting group. Corporations A, B, and C are calendar year taxpayers and are included in a group return. Their return filed for taxable year ending December 31, 2011 uses the single-sales factor formula. Conversely, Corporation D has a fiscal year end on June 30th. The return Corporation D files for the year end of June 30, 2012 uses the standard formula. The first common six-month period for taxable years beginning on or after January 1, 2011 for all of the taxpayers begins on July 1, 2011, and ends on December 31, 2011. The business assets for the last six months of 2011 for electing Corporations A, B, and C are compared to the business assets of non-electing Corporation D for the same time period. If the business assets of electing Corporations A, B, and C are greater than the business assets of non-electing Corporation D for the common six-month period; then Corporation D is deemed to have elected the single-sales factor formula for apportionment. Conversely, if the business assets of non-electing Corporation D are greater than the business assets of Corporations A, B, and C for the common six-month period, there is no single-sales factor formula election for Corporations A, B, or C. For all taxable years thereafter, the business assets test will be based on a comparison of the business assets for the first six-month period of Corporation D's fiscal year.

(5) Election following forced de-combination.

A taxpayer that is subsequently found to not be a member of the combined reporting group pursuant to a Franchise Tax Board audit determination (represented by a notice of additional tax proposed to be assessed, a notice of proposed overpayment, notice of action on a claim for refund, or a letter from the tax auditor regarding a computational effect which does not result in a current year adjustment [e.g., a computation of net operating loss carryover]) may elect to use the single-sales factor formula on an amended return that will be treated as an original return for the purpose of the single-sales factor formula election. The election should ordinarily be made during the course of the audit examination so that the results of that election can be reflected in the applicable notices related to the examination. Except for claims for refund, this election after de-combination must be made no later than 60 days after the date of the applicable notice. This election may be made for each taxable year beginning with the year of de-combination through 60 days after the date of the applicable notice. The Franchise Tax Board may extend such 60-day period for good cause, not to exceed 180 days. In the case of a claim for refund for the entity that was erroneously included in the combined reporting group, a request for the single-sales factor formula election must be made in the claim itself or presented before issuance of the notice of action on the claim. Information to substantiate the effect of the election shall be provided to the Franchise Tax Board within a reasonable time after an election under this subsection is made.

Example 1: Corporations A, B, and C are included in a group return for calendar Years 1 through 6 that includes a single-sales factor formula election. On June 15 of Year 7 the Franchise Tax Board makes an audit determination that Corporation C was erroneously included in the combined report for every year. Corporation C must make the single-sales factor formula election for any of the Years 1 through 6 by August 15 of Year 7. Thereafter, Corporation C may make the single-sales factor formula election on its timely filed original returns.

Example 2: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1 through 6 on December 26 of Year 7. There is no valid single-sales factor election for Years 1 through 6 because the election was made more than 180 days after the audit determination on June 15 of Year 7.

Example 3: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years 1 through 6 on September 10 of Year 7. There is a valid single-sales factor election for Years 1 through 6 provided Corporation C successfully shows good cause for electing more than 60 days after the audit determination of June 15 of Year 7.

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Corporation B determines that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4. Corporation A determines that its apportioning trade or business is not unitary with Partnership

X. Partnership X determines the California source income of Corporation A using the single-sales factor formula as properly indicated on Part B of schedule R-1 of forms 565 for Years 1 through 4. Corporation A makes no election for its separate apportioning trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2, with a determination dated July 15 of Year 6. Corporation B and Partnership X may file amended returns for Years 1 through 4 by no later than September 13 (60 days from the date of audit determination) of Year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula and Partnership X's factors. Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15 of Year 6 and may use the single-sales factor formula to determine the California source income of Corporation B on a timely filed original Part B of schedule R-1 of form 565 for that year.

(6) A taxpayer that is engaged in more than one apportioning trade or business may make a separate election for each apportioning trade or business.

Example 1: Corporations A and B are taxpayers and are affiliated with each other, and are also affiliated with non-taxpayer Corporations C, D, E, F, G, H, and I. Corporations A, C, D, and G are engaged in one apportioning trade or business and form a combined reporting group, Group X. Corporations B, E, F, H, and I are engaged in another separate apportioning trade or business and form a combined reporting group, Group Y. Since both Corporations A and B are members of a combined reporting group that includes at least one California taxpayers, each may independently elect to file on a single-sales factor formula basis for purposes of apportioning business income of their respective combined reporting groups. It is not necessary for both Corporations A and B to make the same election, even though they are members of the same group of affiliated corporations. Corporation A, filing a group return for Group X, may make a single-sales factor formula election for Group X. Corporation B, filing a group return for Group Y, is not required to make a single-sales factor formula election.

Example 2: Corporation W is a taxpayer that owns 50 percent of two separate apportioning trade or businesses, Partnership J and Partnership K, but is not unitary with either partnership. Partnership J determines the California source income of Corporation W using the single-sales factor method on a timely filed original return on Part B of schedule R-1 of form 565. Partnership K makes no election and uses the standard three-factor formula to determine the California source income of Corporation W. Corporation W makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula.

Example 3: Corporation P is a taxpayer that is the single owner of three limited liability companies, Q, R, and S that are each disregarded entities for tax purposes and operate three distinct apportioning trade or businesses. P, Q, R and S are not unitary with one another. Q and R determine the California source income of Corporation P using the single-sales factor formula on timely filed original information returns on Part B of schedule R-1 of form 568. S makes no election and determines the California source income of Corporation P using the standard three-factor formula on Part A of schedule R-1 of form 568. Corporation P makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula on Part A of schedule R-1 of form 100.

Example 4: Same facts as Example 3, except that Corporation P and the disregarded limited liability companies Q, R, and S are unitary. The combined reporting group includes Corporation P (Q, R, and S), Corporation A, and Corporation B filing a group return for Group P. Group P makes a single-sales factor formula election on its timely filed original group return. Since Q, R, and S are disregarded entities operating as divisions of Corporation P and are unitary with each other and Corporations P, A, and B, the income and factors of Q, R, and S are added to those of Corporations P, A, and B, and the single-sales factor formula is used to apportion the income of Group P.

Example 5: Corporation T has elected to be an S corporation. It wholly owns Corporations U, V, and W, each of which satisfies the requirements to be a qualified Subchapter S subsidiary and, pursuant to an election by T, are treated as disregarded entities. T is unitary with W, while T, U and V are not unitary with one another and each operates a separate apportioning trade or businesses. U and V determine the California source income of Corporation T using the single-sales factor formula on a timely filed original return, form 100S filed by Corporation T, with the election indicated on Part B of schedule R-1 attached to schedule QS. Corporation T makes no single-sales factor formula election. Because W is unitary with T and T made no election, W may not determine Corporation T's California source income using the single-sales factor formula. Corporation T does the following: (1) apportions the business income from its separate apportioning trade or business using the standard three-factor formula, (2) adds the income and factors of unitary W to its own income and factors, and (3) adds the California source income from the separate apportioning trade or business of U and V as determined using the single-sales factor formula with U and V's sales factors.

(7) Validity of Election. An election under this regulation will be considered valid if the following conditions are satisfied:

(A) The tax is computed in a manner consistent with the single-sales factor formula election, and

(B) A written notification of election is filed with the return on Part B of schedule R-1 attached to form 100 (S Corporations file a form 100S, and water's-edge

corporations file a form 100W), form 565 (for nonunitary partnerships), form 568 (for nonunitary limited liability companies), schedule QS (for nonunitary qualified Subchapter S subsidiaries), form 540 (for individuals), or form 540NR (for nonresident individuals).

(8) Time for making the election.

(A) The election must be made on a timely filed, original return.

Example: Corporation P is not a California taxpayer, but it has three subsidiaries, Corporations A, B, and C that are taxpayers and are part of its unitary business. No single-sales factor formula election is filed prior to the due date (taking extensions into account) for filing a return. After the due date (taking extensions into account), a delinquent original California return is filed with a single-sales factor formula election by Corporation P, stating that it now believes it had nexus in California. Because the election was not made on a timely filed, original return, there is no valid election.

(B) Timely filings which only supplement a previously filed return, or correct mathematical or other errors, shall be considered as incorporating the previously filed return, to the extent not inconsistent, and shall be treated as the original return for purposes of making a single-sales factor formula election. Any timely filings that clearly reflect an intent to withdraw an election made on a previously filed return shall be treated as an original return.

Example 1: Corporation A is a calendar year taxpayer. Its return is due March 15. But if it files its return on or before October 15, an extension is automatically granted to October 15. If it fails to file a return by October 15, no extension exists. Under the paperless extension process, the return is timely if it is filed on or before October 15.

Corporation A files its original return on October 15 of the year. The original return is timely filed, and any single-sales factor formula election contained therein shall be effective for the year for which the return is filed.

Example 2: Same facts as Example 1 except that Corporation A files its original return on May 15 of the year. The original return is timely filed, and any single-sales factor formula election contained therein shall be effective for the year for which the return is filed.

Example 3: Same facts as Example 2 except that Corporation A files a second return on October 15. Under this regulation, Corporation A's original return was filed on October 15. The single-sales factor formula election must be made by that time. If Corporation A's May 15th filing makes a single-sales factor formula election, and the election is withdrawn in the October 15th filing, the election made on May 15th has no effect. If Corporation A's May 15th filing makes a single-sales factor formula election and the October 15th filing is silent as to the single-sales factor formula election but the calculation of the tax due on the return is consistent with making a single-sales factor formula election, then the

single-sales factor formula election made in the May 15th filing is incorporated into the October 15th filing, which will be considered as the original return. If Corporation A's May 15th filing does not make a single-sales factor formula election, but a single-sales factor formula election is made on the October 15th filing, Corporation A has made a single-sales factor formula election and the October 15th filing is the original return.

Example 4: Corporation B, a calendar year taxpayer, files a return on February 15. Corporation B's return is treated as being filed on March 15, which is the date the election is considered to have been made. Any return filed after March 15 (the due date of the return) will be considered an amended return.

Example 5: Corporation C, a calendar year taxpayer, has a due date for its return of March 15. It files a return on February 15 and files a second return on March 10. The return filed on March 10 is treated as the original return for the year. The election to file on a single-sales factor formula basis must be made on the March 10 filing to be effective. If Corporation C's February 15 filing makes a single-sales factor formula election and the March 10 filing uses the standard formula and does not make an election, the election made on the February 15 return has no effect. If Corporation C's February 15th filing did not make a single-sales factor formula election and a single-sales factor formula election is made on the March 10th filing, Corporation C has made a single-sales factor formula election.

(c) Miscellaneous Provisions.

(1) Partnerships to the extent owned by corporations. Corporations that elect single-sales factor formula apportionment must use the single-sales factor formula for distributive share items of income and factors from unitary partnerships. A partnership may make a single-sales factor formula election on Part B of schedule R-1 of form 565 or form 568 to determine California source income for its nonunitary partners.

Example 1: Partnership Y is owned 50 percent by Corporation A, which is a member of a combined reporting group, Group A, and 50 percent by Corporation B, which is a member of a combined reporting group, Group B. Partnership Y is unitary with Group A but not with Group B. If Group A makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from Partnership Y, adding 50 percent of the sales factor numerator and denominator of Partnership Y to those of Group A and adding 50 percent of total business income of Partnership Y to that of Group A. Partnership Y may make a single-sales factor formula election or may choose to not elect and remain on the three-factor formula to determine the California source income for Corporation B.

Example 2: A limited liability company M has three owners and has made no election for its classification for tax purposes so by default M is treated as a partnership. Each of the three owners of M operate an apportioning trade or business in addition to that operated by M. M is owned 25 percent by Corporation A, 25 percent by Corporation B, and 50 percent by Corporation C. M is unitary with Corporation C, but not with Corporations A or B. If Corporation C makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income

and factors from M, adding 50 percent of the sales factor numerator and denominator of M to its own and adding 50 percent of total business income to its own total business income. M may make a single-sales factor method election to determine the California source income for Corporations A or B. Corporations A and B may independently make single-sales factor formula elections for their own separate apportioning trades or businesses that do not include M.

Example 3: Partnership X operates an apportioning trade or business and is owned 40 percent by a limited liability company (R) taxed as a partnership and 60 percent by a limited liability company (T) that has elected to be taxed as a corporation. All three business entities X, R, and T, are unitary. R is owned 5 percent by nonunitary Corporation A, 85 percent by unitary Corporation B, and 10 percent by nonunitary limited liability company S taxed as a partnership. The combined reporting group of X, R, T, and Corporation B is Group Y. The distributive shares of income and factors from X flows through to R and T. To determine the California source income for the 5 percent distributive share items of income for nonunitary Corporation A, the single-sales factor formula may be used at the R level by R on Part B of schedule R-1 of form 568 using R's factors. The single-sales factor formula may also be used by unitary Corporation B which may elect to use the single-sales factor formula on Part B of schedule R-1 of form 100 if the same election is made by all members of Group Y. Corporation B would add to its own income and factors, its 85 percent distributive share of income and factors from R (which would include R's 40 percent distributive share of income and factors from X) and the combined factors and income would be used on Corporation B's schedule R-1 of form 100 or Group Y's group return. To determine the California source income for the 10 percent distributive share items of income for nonunitary S, the single-sales factor formula may be used at the R level on Part B of schedule R-1 of form 568 using R's factors.

(2) Nonresidents.

(A) Sole Proprietorships. A nonresident individual who is a sole proprietor of a business that engages in activities partly within and partly without the state, as provided in California Code of Regulations section 17951-4, subsection (c)(2), may determine California source income using the single-sales factor formula.

Example 1: Beth Johnson is a nonresident and is the single owner of a sole proprietorship that operates an apportioning trade or business engaged in activities within and without California. Beth Johnson may use the single-sales factor formula on Part B of schedule R-1 for purposes of sourcing her income from the sole proprietorship.

Example 2: John Smith is a nonresident and is the single owner of a limited liability company that operates an apportioning trade or business engaged in activities within and without California. The limited liability company is treated as a disregarded entity for tax purposes. John Smith may make the single–sales factor formula election on Part B of schedule R-1 of form 568 for purposes of sourcing the limited liability company's income.

(B) Partnerships to the extent owned by individuals. A nonresident individual who is a partner in a partnership that engages in activities partly within and partly without the state may determine California source income, as provided in California Code of Regulations section 17951-4, subsection (d)(1), using the single-sales factor formula on Part B of schedule R-1 of form 565, but if the partnership does elect to use the single factor formula, the partnership must use the single-sales factor formula to determine California source income for all nonunitary nonresident partners.

Example: Janet Jones and Bruce Johnson are nonresidents and are partners in an apportioning trade or business that operates as Partnership X. Each of the partners owns 50 percent of the partnership. Partnership X may elect to use the single-sales factor formula on Part B of schedule R-1 of form 565 to determine the California source income of the partners, but if Partnership X uses the single-sales factor formula, it must do so for both Janet Jones and for Bruce Johnson.

(3) Changes in affiliation. Elections are made at the end of each taxable year when changes in affiliation are known. When a corporation is acquired by a combined reporting group and becomes unitary mid-year, the taxpayer members of the combined reporting group have the option of electing to use the single-sales factor formula at the end of that taxable year. The income and factors of the acquired entity are not included in the combined report for the portion of the year before acquisition, and the acquired entity must file a return reflecting its income from California sources and has the option of making its own election for that time period, consistent with this regulation. When a combined reporting group sells a corporation, at the end of the year the taxpayer members of the combined reporting group have the option of making a single-sales factor formula election for the group. The combined reporting group does not include the income and factors of the divested entity for the time period after the sale. The divested entity must file its own tax return for the portion of the year after the sale and has the option to make its own single-sales factor formula election for that portion of the year.

Example 1: Corporation X and its unitary subsidiaries are members of a combined reporting group, Group W, which files on a calendar year basis. Corporation X is a member of Group W from January 1 to June 15 of Year 1. The group return filed by Group W includes Corporation X's income and factors for January 1 through June 14 of Year 1. Group W's taxpayers do not elect to use the single-sales factor formula. Corporation X may make its own single-sales factor formula election for the period starting June 15 through December 31 of Year 1.

Example 2: Corporation A and its unitary subsidiaries B and C are calendar year taxpayers and members of a combined reporting group, Group R. Corporation A acquires Corporation X on June 15 of Year 1. For Year 1, a group return is filed on behalf of the members of Group R with a single-sales factor formula election. The single-sales factor formula election applies to Corporation X for June 15 through December 31 of Year 1.

(d) This regulation shall be applicable to taxable years beginning on or after January 1, 2011.

Note: Authority cited: Section 19503, Revenue and Taxation Code.
Reference cited: Sections 25113 and 25128.5, Revenue and Taxation Code.